

CENTRAL BANK OF ICELAND

# THE ECONOMY OF ICELAND



2000

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## Republic of Iceland

### People

Population.....	278,717 (December. 1, 1999)
Capital.....	Reykjavík, population 109,184 (December 1, 1999)
Language .....	Icelandic; belongs to the Nordic group of Germanic languages
Religion .....	Evangelical Lutheran (95%)
Life expectancy .....	Females: 82 years , Males: 77 years

### Governmental System

Government .....	Constitutional republic
Suffrage .....	Universal, over 18 years of age; proportional representation
Legislature .....	Parliament (Alþingi) with 63 members
Election term .....	Four years, last election May 8th 1999

### Economy

Monetary unit .....	Króna (plural: krónur); currency code: ISK
Gross domestic product.....	ISK 638 billion krónur (US\$ 8.2 billion) in 1999
International trade.....	Exports 34% and imports 38% of GDP in 1999
Per capita GDP.....	ISK 2,3 million krónur (US\$ 31,000) in 1999

### Land

Geographic size .....	103,000 km <sup>2</sup> (39,768 mi <sup>2</sup> )
Highest point .....	2,119 m (6,952 ft)
Exclusive economic zone .....	200 nautical miles (758,000 km <sup>2</sup> \ 292,680 mi <sup>2</sup> )
Climate .....	Cool temperate oceanic; highly changeable, influenced by the warm Gulf Stream and Arctic currents

### Republic of Iceland credit ratings

	Foreign currency		Domestic currency	
	long-term	short-term	long-term	short-term
Moody's Investors Service	Aa3	P-1	Aaa	P-1
Standard & Poor's	A+	A-1+	AA+	-
Fitch IBCA	AA-	F1+	AAA	-

## Contents

1 The Republic of Iceland .....	7
2 Recent Economic Developments and Prospects .....	10
3 The Structure of the Economy .....	16
4 Foreign Trade.....	23
5 Monetary and Exchange Rate Policy .....	26
6 Financial Markets .....	29
7 Public Finance and Foreign Debt.....	33
8 Appendix.....	41

## Tables

Table 2.1	Output and Expenditure 1999 .....	11
Table 3.1	Share of GDP by Industry 1999.....	16
Table 3.2	Percentage Breakdown of Employment by Industries.....	21
Table 4.1	Imports and Exports by Economic Category, 1999 .....	23
Table 5.1	Money Supply, 1998 - 1999.....	26
Table 5.2	Foreign Exchange Reserves of the Central Bank .....	27
Table 6.1	Selected Market Securities .....	30
Table 7.1	Composition of General Government Revenues and Expenditures as % of GDP.....	36

## Figures

Figure 2.1	Economic Growth in Iceland and the European Union 1980 - 2000. ....	11
Figure 2.2	The Current Account in 1990 - 2000.....	11
Figure 2.3	Change in Yearly Averages of Consumer Price Index and Money Supply 1970-2000.....	12
Figure 2.4	Short-Term Interest Rates 1994 - 2000( July) .....	12
Figure 2.5	Long-Term Interest Rates 1991- 2000( July).....	13
Figure 2.6	Official Exchange Rate, Monthly, 1995 - 2000 (August).....	13
Figure 2.7	Public Finances 1993 - 2000 (% of GDP) .....	14
Figure 3.1	Fish Catch of Icelandic Vessels 1970-2000 .....	17
Figure 3.2	The Value of Marine Products for Exports, Percentage Breakdown 1998.....	17
Figure 3.3	Electricity Production in Iceland 1960 - 2005.....	19
Figure 3.4	Primary Energy Supply in Iceland 1960 - 1999 .....	19
Figure 4.1	Growth of Real Export Income and Gross National Income.....	23
Figure 4.2	Volume Growth of Export of Goods and Services 1988 - 2000.....	24
Figure 4.3	Geographical Division of Merchandise Trade in 1999.....	24
Figure 4.4	Terms of Trade in Goods and Services 1945 - 2000 .....	25
Figure 5.1	The Currency Basket Since the Middle of 2000, Based on 1999 Trade Figures.....	27
Figure 7.1	Expenditure Structure of Central Government 1998 .....	33
Figure 7.2	General Government Welfare Expenditures in Selected OECD Countries....	34
Figure 7.3	Welfare Expenditures by Category 1996: Iceland vs. Nordic Countries % of GDP.....	34
Figure 7.4	Expenditure Structure of Local Government 1998.....	37
Figure 7.5	Treasury Foreign Debt 1985-1999, end of year.....	37
Figure 7.6	Euro-Commercial Paper and Other Short-term Credit 1990-2000 (Aug.) ...	38
Figure 7.7	Annual Repayments of Treasury External Funded Debt, 2000-2007 and 2016 .....	38
Figure 7.8	Long-Term External Debt as Percent of GDP and Debt Service as Percent of Export Revenue 1985-1999.....	39

## Appendix

Table A1	Iceland's Membership in International Organisations .....	41
Table A2	Output and Expenditure in 1999-2000, Volume Changes 1997-2000.....	42
Table A3	Balance of Payments 1997-1999.....	43
Table A4	Imports by Economic Category 1996-1999.....	44
Table A5	Exports by Commodity Groups 1996-1999.....	45
Table A6	Geographic Distribution of Foreign Trade 1997-1999 .....	46
Table A7	Projected External Debt Service.....	47

# 1. The Republic of Iceland

Iceland was settled late in the 9th century. The majority of the settlers were of Norse origin with a smaller Celtic element. A general legislative and judicial assembly, Alþingi, was established in 930 and a uniform code of laws for the country was adopted at the same time. In 1262, Iceland concluded a treaty establishing a union with the Norwegian monarchy. When the Danish and Norwegian monarchies were united in 1380, Iceland came under Danish rule, which lasted for more than five hundred years. Iceland was granted a new constitution in 1874 and obtained home rule in 1904. With the Act of Union in 1918, Iceland became a sovereign state in a monarchical union with Denmark. In 1944, Iceland terminated this union with Denmark and founded a Republic.

## Geography and Population

Iceland is located in the North Atlantic between Norway, Scotland, and Greenland. It is the second largest island in Europe and the third largest in the Atlantic Ocean, with a land area of some 103,000 square kilometers, a coastline of 4,970 kilometers and an exclusive 200 nautical mile economic zone extending over 758,000 square kilometers in the surrounding waters.

Iceland enjoys a warmer climate than its northerly location would indicate because a part of the Gulf Stream flows around the south-

ern and western coasts of the country. In Reykjavik, the capital, the average temperature in July is nearly 11 degrees centigrade and just below zero degrees centigrade in January.

Being of volcanic origin, Iceland consists of coastal lowlands and a mountainous interior with several glaciers, the highest of which is 2,119 meters. The coasts are rocky and of irregular outline, with numerous fjords and inlets, except for the south where there are sandy beaches with no natural harbors. Most of the arable land, estimated to be around 20 percent of total land area, is situated along the coast. Most of the population lives in the coastal regions.

With only 2.7 inhabitants per square kilometer, Iceland is one of the least densely populated countries in Europe. The population of Iceland was 279,000 at the end of 1999. The annual rate of population growth was 0.95 percent between 1989-1999. Around 62 percent of the population lives in the capital city of Reykjavik and its surrounding municipalities. The largest town outside the capital area is Akureyri, in the north, with a population of 15,000.

The native language, Icelandic, belongs to the Nordic group of the Germanic languages. The standard of education is high, and public education is compulsory between the ages of six and sixteen. Command of English and Scandinavian languages is widespread.

### **Political Structure and External Relations**

The present constitution was adopted on June 17, 1944 when the Republic was established. Iceland has a parliamentary system of government. Legislative power is vested in the Parliament (Alþingi), and executive power in a cabinet headed by the Prime Minister. The Government has to be supported by a majority of Parliament to remain in power. The 63 members of the Parliament are elected from eight constituencies, on the basis of proportional representation, for a term of four years. A parliamentary bill becomes a law when it is passed by the Parliament and signed by the President. The President is the head of state and is elected for a term of four years by a direct vote of the electorate.

Iceland has a tradition of political stability. Since gaining autonomy from Denmark in 1918, governments have normally been formed by a coalition of two or more political parties. Currently there is an Independence Party/Progressive Party coalition government with a majority in the Parliament.

The results of the 1999 elections were as follows: The Independence Party obtained 40.7 percent of votes and 26 seats, the Progressive Party 18.4 percent and 12 seats, the Social Alliance 25.8 percent and 17 seats, the Left-Green Movement 9.1 percent and 6 seats, and the Liberal Party 4.2 and 2 seats. Others obtained 0.8 percent and no seats. The next general elections are to be held in 2003.

Iceland has participated actively in international cooperation. Iceland belongs to a group of Nordic countries that includes Denmark, Sweden, Norway, and Finland - as well as Greenland and the Faeroe Islands. The Nordic countries have established wide-ranging cooperation in a variety of fields, including economic affairs and international representation. Iceland is a member of the Nordic

Council and specialized institutions such as the Nordic Investment Bank.

Iceland became a member of the United Nations in 1946 and is an active participant in most of its affiliated agencies. Iceland is a founding member of the Bretton Woods institutions that were established in 1945, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). Iceland is one of the original members of the Organization for Economic Cooperation and Development (OECD). It joined the Council of Europe in 1950 and has participated in the Organization for Security and Cooperation in Europe since it was initiated in 1975.

In 1964, Iceland became a party to the General Agreement on Tariffs and Trade, the predecessor to the World Trade Organization (WTO). Iceland joined the European Free Trade Association in 1970 and entered into a free-trade agreement with the European Community in 1972. In May 1992, the member countries of EFTA and the European Union signed an agreement to establish a free-trade zone, the European Economic Area (EEA), which took effect on January 1, 1994.

Iceland is a founding member of the North Atlantic Treaty Organization, established in 1949. A defense treaty with the United States was concluded in 1951. A NATO military base, staffed by United States military personnel, is operated at Keflavik in the southwest of Iceland.

### **Social Services**

The healthcare system is a crucial part of Iceland's extensive welfare system, a system that has been under development for over 100 years. The first old-age pension legislation was passed in 1890, partly to replace assistance to the poor that had been available from local communities for centuries. The first comprehensive social insurance legislation was enact-

ed in 1936. Following enhancements in recent decades, health and social security represented approximately 47 percent of total Government spending in 1998.

The health sector is regulated according to the Health Service Act of 1990 by which all inhabitants have right of access to the best possible health service for the protection of their mental, social and physical health. According to the Act on Social Security of 1993 the social security system comprises insurances such as pension insurance, occupational injury insurance, health and maternity insurance.

Approximately 85 percent of total medical billings are paid out of public funds. While hospital treatment is free, patients pay for part of most ambulatory care and pharmaceuticals. The country is divided into health care regions, each with their own primary health care centres, some of which are run jointly with the local community hospital. Ambulatory care is provided in outpatient clinics at major hospitals and by specialists in private practice.

Life expectancy in Iceland is among the highest in the world and infant mortality among the lowest in the world.



## 2. Recent Economic Developments and Prospects

The prospects for economic progress in Iceland continue to be favorable although growth is expected to slow down in 2000 and 2001. The pressure of inflation has been felt while unemployment has practically disappeared. To counter overheating tendencies in the economy the Central Bank raised its interest rates thrice in 1999 and twice in the first half of 2000. The current account balance is in deficit, and the terms of trade have deteriorated somewhat inter alia because of rising oil prices. In recent months the exchange rate of the króna has depreciated slightly to a level slightly above the central rate.

### Growth and Trade

The economy grew by nearly 5 percent annually from 1996-1999. Now there are signs that growth will slow down in 2000 and 2001. The National Economic Institute (NEI) estimates the growth rate of gross domestic product (GDP) to be 3.7 percent in 2000 and 1.6 percent in 2001. For the period 2001-2004 economic growth is forecast to average around 2.25 percent per year. This is slightly lower than the forecast for the European Union. Figure 2.1 shows the annual rate of economic growth in Iceland and the European Union.

In recent years economic growth has been driven mainly by an expansion in gross fixed investment and private consumption while exports and public consumption have

been growing more slowly. In 2000 exports are expected to grow by only 0.9 percent. The main reason for stagnation in export growth is a reduction in cod quotas. Investment grew by 10 percent in 2000 but will fall by 3.5 percent next year. Imports will grow by an estimated 4.7 percent in 2000 but a reduction to 2 percent is expected next year. Export of services has continued to grow briskly. A record number of tourists, 187,000, visited Iceland in the first seven months of the year 2000; the total for the year is forecast to be just over 300,000.

Catches of cod in the first six months of 2000 declined by over 5 percent compared to the same period in 1999 while total fish catch was 16 percent higher in tons, the increase mainly due to good capelin catches. The cod quota for the fishing year September 2000 to September 2001 will be 30,000 tons less than the 250,000 tons allocated for 1999-2000.

Prices of marine products have fallen slightly in the first half of 2000 after a substantial rise in 1998. The long-term outlook for an increase in marine export prices is, however, favorable, because the supply conditions of demersal fish have deteriorated worldwide. Cod quotas, for example, in the Barents Sea and EU waters were sharply reduced for the year 2000. Fishmeal and fish oil are standardized products, subject to price competition from substitute products such as soy oil. The prices of aluminum and ferro silicon, which

Table 2.1 **Output and Expenditure 1999**

Billion ISK	Volume changes percent	
	1999	98/99
Private consumption	400	7.2
Public consumption	138	4.7
Capital formation	127	-2.0
Stock changes	0.14	-0.1
Total national expenditure	665	4.7
Exports of goods and services	215	5.8
Imports of goods and services	243	6.3
Gross domestic product	638	4.4
Net factor income from abroad	-14	-
Current transfers, net	-0.7	-
Current account balance	-43	-

Source: National Economic Institute; April 2000 estimation.

suffered in 1998-- partly due to the Asian crisis-- have been slowly recovering. Terms of trade for goods and services improved by

around 5 percent in 1998 but have been mostly stable since.

### The Balance of Payments

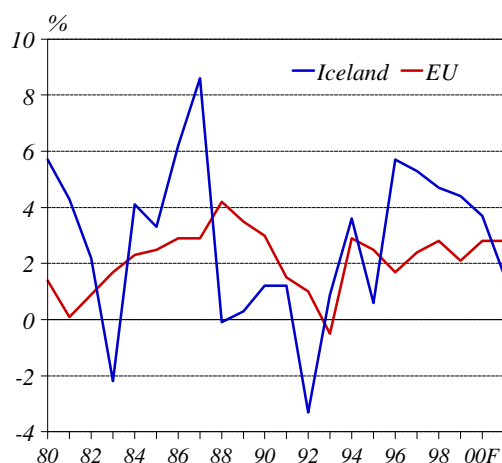
Import of goods is forecast to exceed export by around ISK 30 billion in 2000 compared to 23 billion in 1999. In volume terms, merchandise imports are forecast to increase by 4.7 percent and the value of merchandise exports to decrease by 0.2 percent in 2000. Export of services will increase by around 3.3 percent but import by 4.7 percent, resulting in a negative balance of close to 5 billion. For the year 2000 the National Economic Institute forecasts that the current account will be negative by ISK 55 billion - or 7.8 percent of GDP, while in 1999 the deficit was 6.7 percent of GDP.

### Prices and Wages

The rate of inflation in 1999 was somewhat higher than in the previous years. The Consumer Price Index (CPI) rose by 5.8 percent from January 1999 to January 2000. This implies an increase of 3.4 percent from the

Figure 2.1

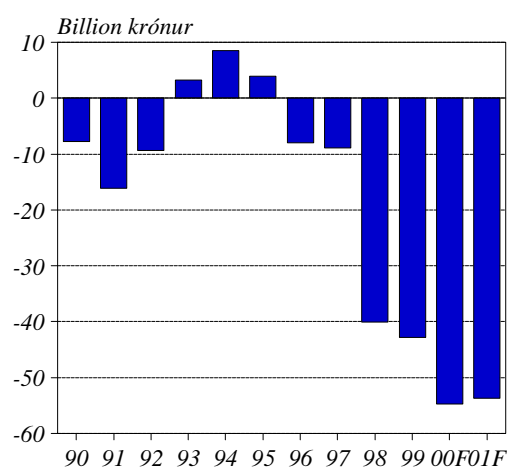
#### Economic Growth in Iceland and the European Union 1980-2000



Source: National Economic Institute.

Figure 2.2

#### The Current Account 1990-2001



Source: National Economic Institute.

annual averages of 1998 and 1999. The Central Bank now forecasts an inflation rate of around 5.8 percent between 1999 and 2000. A new wage settlement - the terms of which are to be in effect for a period of three years - negotiated early in the year 2000 led to relatively modest increases in wages. This settlement in combination with a tight monetary and fiscal policy should help to preserve the price stability that has prevailed in the last decade.

Real disposable income rose in 1999 by an estimated 5 percent and is forecast to rise by 1.5 percent in 2000. The real exchange rate of the króna appreciated by 2 percent during 1999 but is forecast to appreciate by 4.9 percent during this year.

Unemployment continues its declining trend. The unemployment rate declined in 1998 to 2.8 percent of the labor force, fell below 2.0 percent in 1999 and has fallen even lower in the first half of 2000. This is the lowest unemployment rate among the OECD countries. Employees in specific groups with particular educational backgrounds and skills are in short supply. These include computer

experts, business administration graduates, and skilled labor. Foreign labor has increasingly helped to relieve labor shortages especially in the fishing industry around the country.

### Outlook for the Year 2001

Economic growth is expected to slow down to 1.6 percent in the year 2001. The main reason is a decline in private consumption and a 1.1 percent negative export growth, due to a contraction in cod catch. For 2001 the Central Bank forecasts an inflation rate of around 5 percent year-on-year or 3.8 percent within the year.

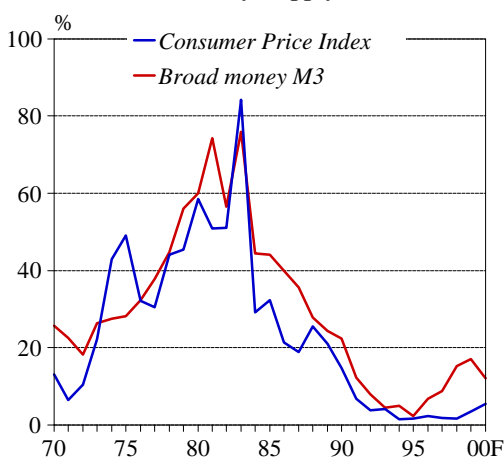
The current account is not likely to improve significantly and terms of trade appear to be similar as in the year 2000. The investment boom has slowed down and a contraction of around -3.5 percent is forecast for the year 2001. The level of unemployment is expected to remain at the present level.

### Monetary Policy

The main task of monetary policy continues to be combating growing inflationary pressures

Figure 2.3

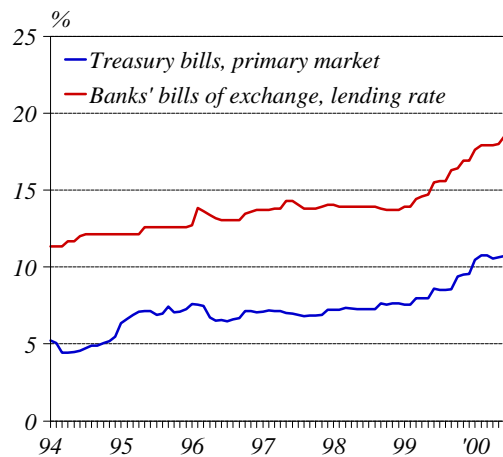
Change in Yearly Averages of Consumer Price Index and Money Supply 1970-2000



Source: Central Bank of Iceland.

Figure 2.4

Short-Term Interest Rates  
1994- 2000 (July)



Source: Central Bank of Iceland.

and restraining demand. The aim is to bring inflation down to a level similar to that of Iceland's main trading partners. Recent inflationary expectations, rapid credit expansion, and large private sector financing through foreign borrowings have contributed to the overheating of the economy. The Central Bank will be alert to turning points in developments that may warrant a revision of the present tight monetary stance.

In January 2000, the key short-term Central Bank rate, the repo rate, was increased by 0.8 percent to 9.8 percent, in February by 0.3 percent to 10.1 percent and in June by 0.5 percent to 10.6 percent. In February the fluctuation band of the exchange rate of the króna from the central rate was increased from  $\pm 6$  percent to  $\pm 9$  percent.

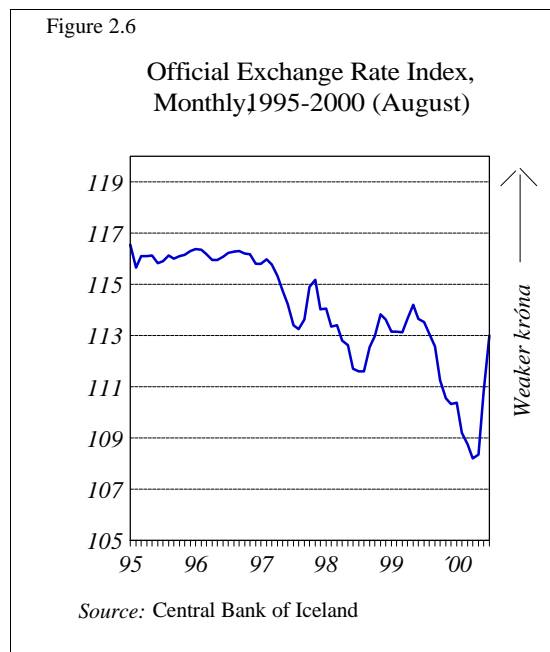
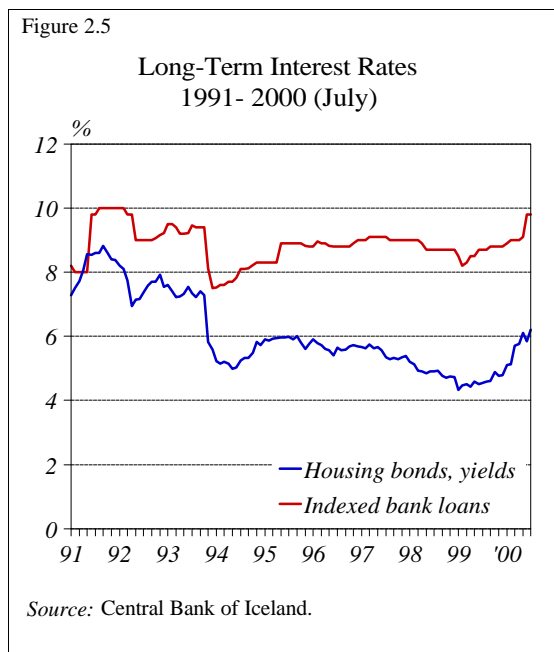
The yields in the domestic money market have been substantially higher than trade-weighted foreign money market rates abroad. The difference was more than 5 percent after an interest rate increase in September 1999 and was around 6 percent in July 2000. The monetary stance eased nevertheless in mid-2000

because of higher inflationary expectations and depreciation of the króna.

The króna came under pressure in mid-June and again in the beginning of July. Hopes of the króna remaining as strong as in the first months of the year 2000 dwindled, probably as a result of poorer prospects for fish catches, current account, and inflation. The Central Bank firmly intervened, and the króna strengthened again -although it has depreciated by 3.6 percent since the beginning of the year.

Notwithstanding a gradual tightening of monetary policy, interest rates on long-term indexed Government bonds and housing bonds in the secondary market continued to decline until the beginning of 1999, reducing the restrictiveness of monetary policy.

Subsequently, and particularly in the first half of 2000, these interest rates and bank lending rates have risen sharply. Monetary aggregates, however, continue to grow at an unsustainable rate, although credit expansion has slowed down from 1999. The 12-month growth of bank credit was approximately 25 percent in the first half of 2000. The growth



rate of Broad Money (M3 including accrued interest) has been somewhat slower, recently between 10-15 percent. The higher growth rate of credit reflects the degree to which the banks have resorted to foreign borrowing to finance their lending activities.

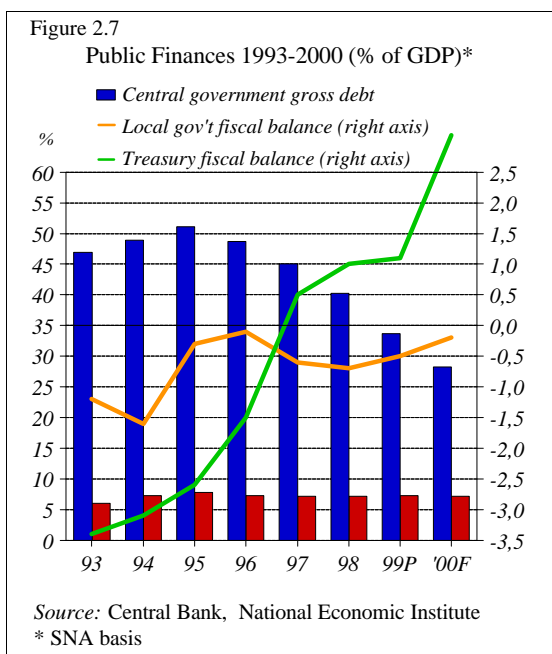
### Public Finance

The Treasury's accounts for 1999 are due in August. By preliminary Central Bank estimates, the Treasury ran a surplus of around ISK 16 billion on accruals basis in 1999, approximately 2.5 percent of GDP and 8 percent of Treasury revenues. By similar preliminary estimates, the combined deficit of municipalities was around ISK 3 billion or 0.5 percent of GDP and 5 percent of municipal tax revenues.

According to the budget for the year 2000, the Treasury surplus was expected to widen to around ISK 17 billion. The strengthening of the underlying budget is significantly larger, since privatization profits were to drop from an estimated ISK 11 billion in 1999 to a budgeted ISK 4.2 billion in the year 2000.

These profits cannot be considered part of regular Treasury revenue because they accrue as a result of a bookkeeping convention that counts - as revenue - proceeds from privatized Government enterprises above book value. By mid-year indications, the year 2000 surplus should exceed ISK 20 billion, assuming that privatization profits will be on target. The local government deficit is expected to decrease to around ISK 1 billion or 0.1 percent of GDP, mostly because of temporary conditions. In the medium and longer perspective local government finances remain weak.

By preliminary figures, Treasury revenue rose by 14 percent in nominal terms between 1998 and 1999, while prices rose by 4 percent gauged by the GDP-deflator and wages rose by almost 7 percent. The heftiest revenue increase came from privatization profits, which rose from ISK 2.5 billion in 1998 to ISK 11 billion or 5.5 percent of total revenues in 1999. Other revenues rose by 9.5 percent, led by a 17.5 percent rise in personal income tax receipts and 19 percent in corporate income tax receipts. Revenues from taxes on goods and services rose by 10 percent, as did revenues from payroll taxes. The disproportionate rise in personal income taxes is at least partly the result of a threshold effect: The relatively high level of tax-exempt income, around US\$ 10,000 per year for individuals, was raised by only 1.6 percent at the beginning of the year and was left far behind by wages, which rose at a rate of 7 percent while employment grew at an estimated 2.5 percent. Corporate income being inherently more volatile than personal income, revenue from corporate income taxes were boosted by buoyant profits, the erosion of carry-forward losses, and Government enterprises at various stages of privatization graduating from special dividend payment arrangements to ordinary taxpayer status.



Behind the ISK 17 billion Treasury surplus budgeted for the year 2000, there was a projected 2 percent nominal growth of revenues over the previous year, but more importantly, a 5 percent growth of revenue excluding privatization profits. Expenditures were budgeted to rise by just 1 percent in nominal terms in the face of 3 percent forecast real growth of GDP and 4.5 percent inflation on the GDP-deflator. The brunt of this real expenditure cut lay in lower interest payments, pension charges, fixed investment, and a stay in health sector outlays. Health sector outlays had risen by a nominal 20 percent (real 9 percent) between 1998 and 1999, in part due to late funding of previous overruns. Other expenditures were to rise by around 7 percent or 2 percent in real terms.

Indicators for mid-year 2000 suggest that revenues may end up around 6 percent over budget against a 4 percent overrun in expenditures, widening the surplus to more than ISK 20 billion and around 3 percent of GDP. An apparent failure to contain health-care and general expenditures must, however, be considered a disappointment.

The strength of the budget must be viewed in light of the current expansion. Unemployment is exceptionally low at 1.5-2 percent. A trade deficit of roughly ISK 30 billion (4 percent of GDP) as well as high private consumption relative to GDP (62.5 percent versus an average of 60 percent in 1993-1997) tend to boost Treasury tax revenue. A casual look at recent changes in the personal income tax system suggests that it has been administered to maintain a rather high real level of tax-

exempt income over the cycle. Under this system, the Treasury pays the flat 12 percent municipal income tax for low-income taxpayers. Both of these aspects increase the procyclical tendency of personal income tax revenue. Adding the procyclical nature of corporate income taxes, the expansion is responsible for much of the budget surplus. Estimates do nevertheless indicate that the budget would remain firmly in surplus even if corporate profits and the unemployment level were to return to more normal levels and even if imports fell, which would slash the trade deficit and private consumption.

### **Privatization**

The sale of the remaining 51 percent of the total equity of FBA - The Icelandic Investment Bank (Fjárfestingarbanki atvinnulífsins) was completed in November 1999. The new shareholders are a variety of individual, corporate, and institutional investors. Further privatization of public enterprises, especially those competing with private sector enterprises, is on the Government's agenda. Two state-owned commercial banks, Landsbanki Íslands and Búnaðarbanki Íslands, were incorporated in 1998 - and later in the year, the banks issued new equity for sale to the public. The Government sold 15 percent of its share in these banks to the public in December 1999. Shares in the banks were sold both by subscription and bid. These changes are the first step towards a full privatization of these institutions. Full privatization, however, requires special approval by Parliament.

### 3. The Structure of the Economy

Disadvantages caused by the small size of the population have not stood in the way of economic growth and prosperity in Iceland. Living standards are among the highest in the world. The economy, based on fisheries and agriculture at the beginning of this century, has diversified into manufacturing and service industries in recent decades. Important primary and secondary industries are based on the use of renewable natural resources, namely the coastal fishing banks, hydroelectric power, and geothermal power. Iceland also has ample resources of cold water that is excellent for

human consumption as well as for industrial use. Tertiary activities employ around two-thirds of the manpower and significant new developments have taken place in activities based on investment in human capital such as software production, financial activities, and biotechnology.

The estimated contribution of the various industrial sectors to the total GDP in 1998 is shown in table 3.1.

#### **Fishing and Fish Processing**

The marine sector, including fishing and fish processing, is the main export sector. In 1999, 67 percent of merchandise exports (about 45 percent of total exports) originated in this sector. In the early 1960s, exports of fish and fish products constituted over 90 percent of merchandise exports.

The principal part of the Icelandic marine sector is the stock of groundfish, including species such as cod, haddock, saithe, and redfish. The catch of groundfish reached a maximum of 716,000 tons in 1981 but declined shortly thereafter. In 1999, the catch of demersal species is estimated to be around 509,000 tons. Conservation measures led to substantial cuts in cod quotas in early 1990s, cod being the single most valuable species in Icelandic waters. The fishing industry offset the cuts by increasing catches of other species and by fishing beyond Iceland's exclusive 200-

Table 3.1 **Share of GDP by Industry 1999**

	%
Agriculture	2.1
Fishing	7.5
Fish processing	3.6
Manufacturing, water and electricity supply	20.8
Construction	7.8
Trade, restaurants and hotels	15.3
Finance, insurance, real estate and business services	18.9
Transportation	9.5
General government	13.1
Miscellaneous private services and other activities	6.0
Imputed bank service charges	(4.5)

Source: National Economic Institute

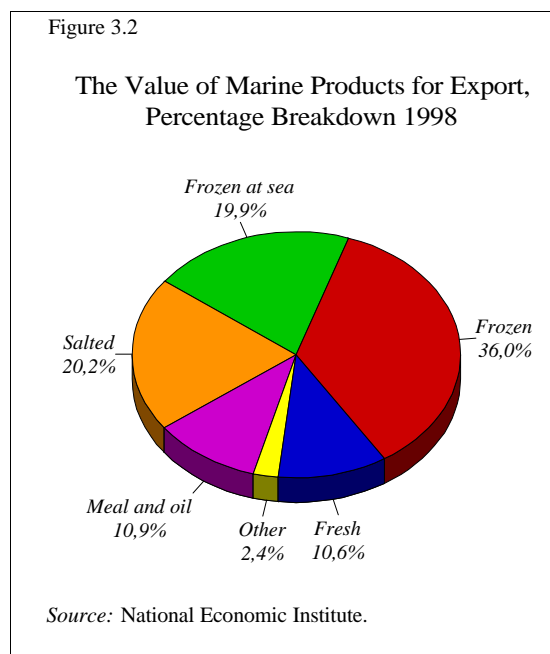
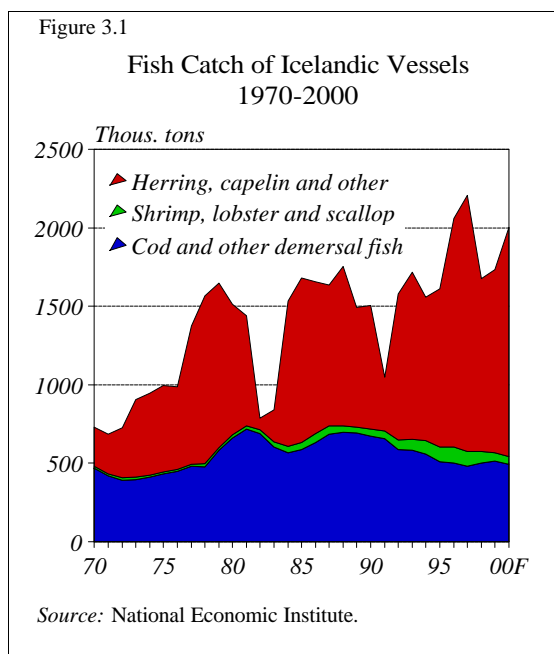
mile fishing zone. More efficiency has been achieved by selective catches, catch landed by foreign vessels has increased, and a larger share of the catch has been processed domestically. In the last several years, the cod stock has been recovering. Apart from groundfish and shrimp, the most important fish for Iceland's marine sector is capelin, a small fish of the salmon family. The capelin catch in 1999 was 704,000 tons, down from a record catch of 1,319 tons in 1997. The National Economic Institute estimates that the total catch will be one million tons in 2000.

The catches of shrimp, lobster, and shellfish have been of substantial value in recent years as well as catches of herring, which used to be one of the most important fish in the sixties. Well over half of export value in fish products is frozen fish, but putting fish on ice and salting fish are also important processing methods. The production of fishmeal and fish oil has been subject to considerable changes and price volatility.

A comprehensive fisheries management policy has been developed to manage the fish

stocks. Quotas regulate catches of all the major species of fish. The total allowable catch is determined on the basis of biological estimates of the status of the fish stocks and forecasts for their development in the near future. This quantity is then allocated among individual fishing vessels and the quotas can be traded between companies at market price. The fishing quotas were originally allocated, free of charge, to fishing vessels on the basis of fishing experience as measured by the average catch for the last three years before the first allocation in 1986. A substantial market for fishing quotas has developed since 1990.

The fish processing industry increasingly relies on computers, electronics, and modern management techniques, as well as research and development in biotechnology. The production systems are flexible, and it is relatively easy to divert the raw material to the most profitable processing method whether it is freezing, salting, or drying. The technologically advanced fishing fleet includes vessels that can perform high-quality processing at sea. In recent years the number of companies in this





sector has declined and their average size increased due to several corporate mergers. In September 1999, the merger of two large salted and frozen fish export companies created the largest private company in the country with a total turnover of ISK 50 billion. Concurrently the number of small private boats that operate close to shore has greatly increased in recent years as well as their share of the total catch.

Increased quality and diversification extends not only to processing, but also to marketing. Icelandic fish products have been actively marketed in the United States, Europe, and Japan, and Icelandic products have acquired widely established brand names. Progress in the marine industry has to a certain extent limited the risks associated with Iceland's dependence on export of marine products as is evident by rapid adjustment to the loss of markets in Japan and elsewhere because of the recent Asian crisis. Icelandic firms have also been buying established businesses in the field of fish processing and distribution in various countries.

### **Manufacturing and Power Intensive Industries**

The largest manufacturing industries in Iceland are based on the extensive use of electric power and produce for export. Various small-scale manufacturing units produce mainly for domestic consumption although an increasing number is also producing for exports. In 1999, manufactured products accounted for approximately 26 percent of total merchandise exports.

The development of power intensive industries is based mainly on competitive energy prices that can be offered in Iceland. The Government has been encouraging investment from foreign enterprises to develop such industries. Production of aluminum and ferrosilicon contributed to approximately 1.6 percent of GDP in 1999. The largest manufacturing facil-

ity in Iceland is an aluminum smelter located at Straumsvik near Reykjavik. The smelter is owned and operated by the Icelandic Aluminum Company Ltd, ISAL, a wholly owned subsidiary of Alusuisse Lonza AG of Switzerland. A 60,000-ton expansion of the Straumsvik smelter was completed in September 1997 bringing total capacity to 162,000 tons per year. Nordic Aluminum, which is owned by the US company Columbia Ventures, completed the building of the first phase of a new 60,000-ton aluminum smelter at Grundartangi in June 1998. A capacity expansion of 30,000 tons is now under construction to be completed in 2001. The Icelandic Government, Elkem A/S of Norway, and the Sumitomo Corporation of Japan, jointly own a 72,500-ton ferrosilicon plant, Icelandic Alloys Ltd, Jarnblendifelagid, at Grundartangi in Hvalfjordur on the west coast of Iceland.

Four medium-sized manufacturing enterprises, a fertilizer plant, a cement plant, a rock wool plant, and a seaweed meal plant use locally available raw materials to produce for export (rock wool, seaweed meal) and the domestic market. The products of other manufacturing industries include fishing gear, packaging for exports, building components, machinery, equipment repair and maintenance, soap and related chemical products, plastics, ceramics, food products, beer, liquor, soft drinks, paint, and furniture.

Geothermal steam has been used successfully in a diatomite plant in northern Iceland. Geothermal steam is available in several other places and can be of potential use in many industries as well as in the production of electricity.

In recent years, there has been a brisk growth of various high-technology industries such as pharmaceuticals, the computer software industry, and biotechnology. These industries are first and foremost based on investment

in human capital. Production of equipment and electronic appliances for fishing and fish processing has also developed successfully. This development is supported by specialized knowledge and experience obtained from fisheries and fish processing.

### Agriculture

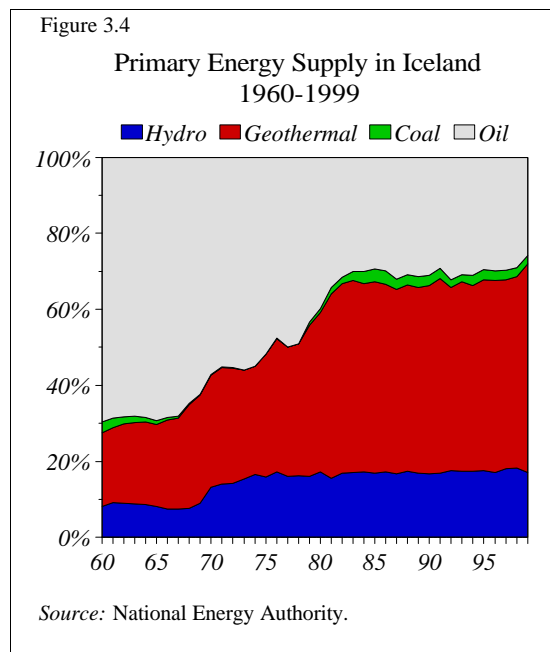
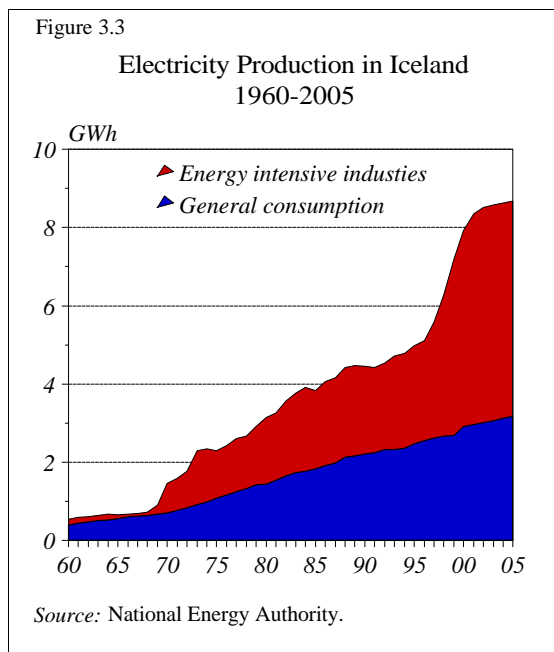
Approximately one-fifth of the total land area of Iceland is suitable for fodder production and the raising of livestock. Around six percent of this area is cultivated, with the remainder devoted to raising livestock or left undeveloped. Production of meat, dairy products, and eggs is mainly for domestic consumption. The principal crops are hay and potatoes. Experimental production of other crops, such as barley, has yielded promising results. Vegetables, flowers, and even some fruits are cultivated in greenhouses heated with geothermal water and steam. A fur industry has developed and knitted clothing made of Icelandic wool is a popular export item.

The agricultural sector has undergone structural changes in recent years. Demand for

traditional products, especially lamb and mutton, has declined substantially while consumption of pork and poultry has risen in line with increased productivity and efficiency, especially in the production of pork. Price support and export subsidies for the traditional products, sheep and milk, have been replaced with subsidies in the form of direct income payments to farmers. In the agricultural fiscal year from October 1997 to October 1998, these direct payments are estimated to amount to 42 percent of the farmers' costs in raising lamb and to 40 percent of the costs in milk production. Subsidies to farmers amounted to about 1.5 percent of GDP in 1998. Imports of meat, dairy products, and vegetables that compete with domestic production are subject to high tariffs, controls to prevent diseases, and seasonal quotas. Imports are likely to increase as tariffs go down in line with the WTO agreement on trade in agricultural products.

### Energy

Iceland has extensive hydro and geothermal resources. Electric power potential from hydro



and geothermal sources is estimated to be 50,000 GWh per annum, taking economic and environmental considerations into account. In 1998, the use of electricity in Iceland was approximately 6,300 GWh per year which means that less than 15 percent of the power potential, as estimated by the National Energy Authority, has been harnessed. Furthermore per capita consumption of energy is close to being the highest in the world. A new 120 MW hydropower station, Sultartangavirkjun, was completed in 1999.

All towns and villages and virtually all farms are connected to the public power utilities. All the largest hydroelectric power plants as well as the inter-regional power lines are owned and operated by the National Power Company, Landsvirkjun, which is the prime supplier of electricity in Iceland. The State owns 50 percent of the company, the City of Reykjavik owns 45 percent and the Township of Akureyri owns 5 percent of the company.

Hot water from geothermal sources and natural steam is extensively used for residential heating and cultivation in greenhouses. Approximately 85 percent of all households are heated with geothermal energy. In industry, geothermal heat is mainly used for the drying of seaweed and for the production of diatomite and salt.

Almost all of the electricity consumed is produced by indigenous energy resources, hydro and geothermal energy. Oil is only used to meet peak demand and as a reserve resource. Imported oil is used mainly in transportation, for the fishing and commercial fleets and the industrial production of fishmeal and fish oil. Oil imports (fuels and lubricants) accounted for around 5 percent of the total value of merchandise imports in 1999, as compared to 19.3 percent in 1979 when oil prices were exceptionally high.

### **Transport and Communications**

The domestic transportation network consists of roads, air transportation, and coastal shipping. Car ownership is widespread. Iceland had 510 passenger cars per 1,000 inhabitants in 1998 as compared to the United States that had 565 (1994) and Denmark 312 (1994). Several airlines operate in Iceland. Icelandair (Flugleidir) is a private company with international routes and direct flights from Iceland to a number of cities in Europe and the United States. Air Atlanta mainly operates as a charter airline on international routes outside Iceland. Some foreign airlines also operate routes to Iceland with maximum activity during the summer. The domestic market is dominated by two private airlines namely Flugfelag Islands, owned by Icelandair, and Islandsflug. Both airlines run routes between several towns and villages around the country and the former also runs routes to Greenland and the Faeroe Islands.

Iceland has numerous harbors that are almost without exception free of ice throughout the year. In exceptionally cold years, drift ice from Greenland can close harbors in the northern part of the country. The three main shipping companies, Eimskip, Samskip and Nesskip, operate regular shipping routes to the major ports of Europe and the United States.

In January 1998, the Post and Telecom Iceland was divided into two separate entities, Iceland Post and Telecom Iceland. The telephone and telegraph system, operated by Telecom Iceland, is both extensive and modern, with satellite earth stations, optical fiber cables, and an extensive cellular mobile phone system. Iceland Post and Telecom Iceland are limited liability companies owned by the Icelandic State. This sector is developing rapidly and competition is increasing. New private companies are being established offering various services such as Internet connections and GSM services. The first such private firm,

Tal hf, commenced operations in 1998.

The Public Broadcasting System, Ríkisutvarpid, operates two radio channels and one television channel, covering virtually the whole country. Íslenska útvarpsfelagid is a private company that operates television and radio channels. Skjareinn is a new television company. In addition, there are several private radio stations and a few local television stations.

### The Labour Force

In 1999, the total Icelandic labor force was estimated to be 137,000 man-years. Women accounted for 43 percent of the total estimated labor force (in man-years) in 1999. The overall participation rate has increased considerably in the last decade, primarily due to increased participation of women. In Iceland, approximately 84 percent of the population between the ages of 16 and 74 belongs to the labor force. (The participation rate for both the elderly and the young is relatively high compared to neighboring countries. In July 2000, unemployment was 1.7 percent of the labor force as measured

in man-years, 1,101 females and 523 males). The working week in Iceland is considerably longer than in other OECD countries. Early retirement is rather uncommon, and retirement age is between 65 and 70.

Most Icelandic employees are members of trade unions. The majority of the larger trade unions of private sector employees are affiliated with the Federation of Labor. Most of the trade unions of public sector employees are affiliated either with the Federation of Public Employees or the Federation of University Graduates.

### Service Industries

The tourism sector has been one of the fastest growing industries in recent years. Foreign visitors in 1999 numbered 263,000, compared to 129,000 in 1987. The foreign exchange revenues generated by tourism in 1999 amounted to approximately ISK 28 billion, a 3.4 percent increase from the previous year. Whale watching is an example of a new tourist activity that has been growing rapidly in recent years. Conditions for whale watching in Iceland are among the best in the world.

Many important structural changes have been implemented in the financial sector in the last decade. Among these are interest rate liberalization, elimination of automatic access to the Central Bank's facilities by the Treasury, liberalization of foreign exchange regulations, and establishment of foreign exchange market- as well as the establishment of a stock exchange, the development of secondary markets for public and private bonds, liberalization of invisible transactions, long-term capital movements and cross-border financial services, and the development of various new financial instruments. Banks and specialized financial institutions are capable of offering a full range of financial services needed by enterprises, whether they are producing for the domestic or foreign markets. In addition to

Table 3.2 **Percentage Breakdown of Employment by Industries** (man-years)

	1990	1997
Agriculture	5.5	4.0
Fishing	5.6	4.7
Fish processing	6.0	5.9
Manufacturing other than fish processing	12.7	11.9
Construction and energy	10.1	9.1
Trade, restaurants and hotels	14.3	15.6
Communication	6.9	6.8
Finance, insurance and business services	8.2	9.0
Public sector	18.3	19.6
Miscellaneous	12.3	13.2
Total	100.0	100.0

Source: National Economic Institute

financial services there has been rapid growth of other business services including computer services and software development.

### **The Environment**

Compared to other industrial countries, Iceland is relatively unpolluted and faces few immediate environmental problems. Electricity and geothermal heating, Iceland's main energy sources, are generated by the use of renewable resources. Utilization of hydroelectric power, however, requires the building of dams and large reservoirs that can affect the landscape. The acid disposition over Iceland is very low, due to Iceland's geographic location and the limited emissions of pollutants. Emission of

greenhouse gases from Iceland in the year 2000 is predicted to be 15 percent higher than in the year 1990. If emissions from new power intensive industries are excluded, emissions in the year 2000 will not exceed the 1990 level. The emission limit set for Iceland in the Kyoto Protocol for the period 2008-2012 amounts to a 10 percent increase from the 1990 levels. The largest emitter is the fishing fleet, followed by the transport sector, and thirdly, various industrial processes. The marine environment around Iceland is believed to be relatively unpolluted. Soil erosion is still a problem, especially in areas used for raising sheep. Considerable work is being carried out to regain badly eroded land.

## 4. Foreign Trade

The foreign trade of Iceland is characterized by a relatively high ratio of trade to GDP, a high ratio of primary exports, concentration in export production, geographical concentration of export markets, and limited intra-industry trade and specialization. These are trade characteristics generally found in small economies.

Iceland imports a wide range of manufactured goods, raw materials, and foodstuffs. The great variety of imports needed results from the small size of the economy, limited manpower, and a limited range of natural resources. Table 4.1 shows imports and exports by main economic categories.

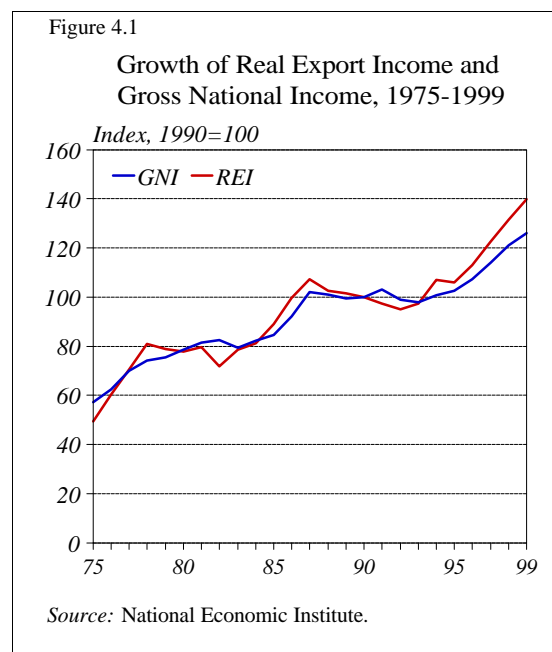
Table 4.1 **Imports and Exports by Economic Category, 1999**

<i>Billions of ISK</i>	<i>Imports CIF</i>	<i>Exports FOB</i>
Food and beverages	17.5	90.0
Industrial supplies	43.8	41.3
Fuels and lubricants	9.7	-
Capital goods	43.8	3.7
Transport equipment	31.3	6.7
<i>Passenger motor cars excl. busses</i>	<i>14.2</i>	<i>-</i>
Consumer goods	35.8	2.2
Other	0.2	1.1
Total	182.3	145.0

Source: Statistics Iceland

The growth of the export sector largely determines the rate of growth of the economy as a whole. Imports and exports of goods and non-factor services averaged 67 percent of GDP during the period 1990 to 1997. Growth of exports averaged 3 percent per annum during this period and imports grew by 2.8 percent while GDP grew by 2.0 percent. From 1945 to 1997, exports grew by 4.6 percent per annum on the average while GDP grew by 4 percent.

In figure 4.1, the relationship between the growth of gross national income and real export income since 1975 is shown.



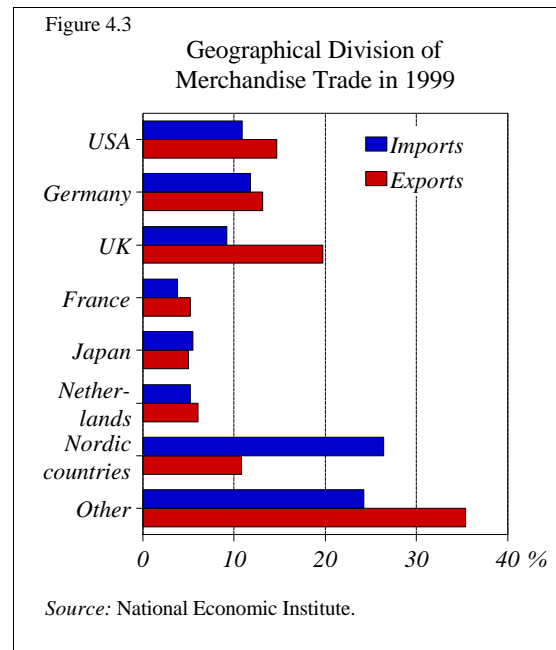
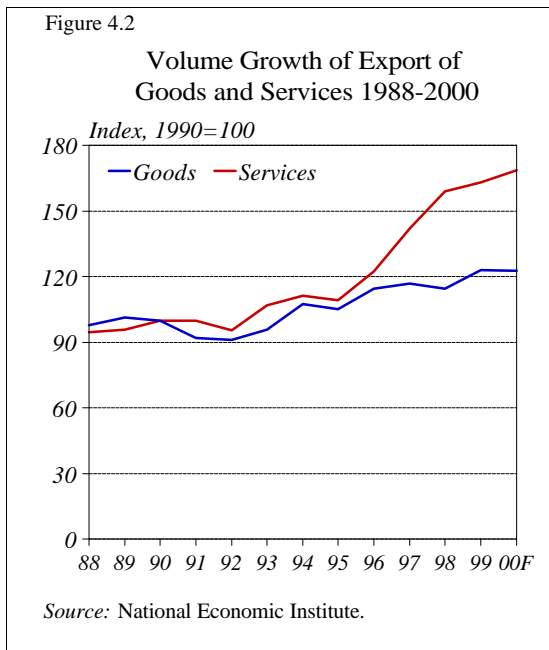
Real export income is a proxy for the buying power of exports and in some cases it reflects the development of the export sector better than volume indices, especially when the volume of exports is very volatile, as in the case of Iceland, due to large swings in fish catch. Real export income is calculated by dividing the index of export income by the index of import prices. The growth trend of real export income averages 2.8 percent per annum. Periods of slow growth are characterized by reduced fish catches or fall in prices of marine products. Promising new export products that are being developed in fisheries equipment, pharmaceuticals, software, and biochemistry should help to stabilize export earnings.

Growth of export in services has been rapid in the last decade. Growth of services has helped to diversify the export industries and make the economy less vulnerable to supply and demand conditions in the marine industry. Revenues from the export of non-factor services account for close to one-third of Iceland's total export earnings. Service income has risen

considerably in recent years, mainly due to a substantial increase in tourism.

Free international trade is of paramount importance to Iceland. Small countries face a dilemma. They must specialize in few export items in which they have a comparative advantage to obtain some economies of scale in production. At the same time specialization in few export products makes a small country more vulnerable to external market instabilities and trade restrictions. Iceland has increasingly supported and participated in international efforts aimed at freer trade both at the regional and international level.

Iceland made a free-trade agreement with the European Community in 1972, under which tariffs on most industrial products were removed. Under the agreement on the European Economic Area (EEA) between EFTA and EU, effective January 1, 1994, Iceland and other EFTA countries generally participate in the free cross border movement of capital, labor, goods, and services within the EEA. Certain provisions are subject to implementing legislation in Iceland and elsewhere.



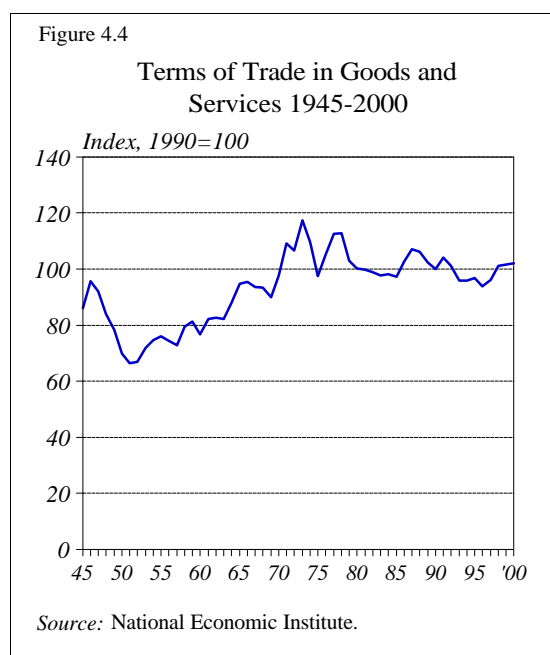
A free-trade agreement is being negotiated between the EFTA countries and Canada.

Tariffs in Iceland on most industrial products have been greatly reduced as a result of EEA, EFTA, and WTO membership. Many agricultural products are, however, still subject to high tariffs. They should gradually lower as the WTO agreement on trade in agricultural products becomes more effective. Tariffs and import levies on general imports and cars constitute between 4 and 5 percent of Treasury income.

In 1999, 64 percent of merchandise exports went to the countries within the European Economic Area and 56 percent of imports originated in the EEA. Currently, Iceland's largest trading partners are the United Kingdom, Germany, the United States, and the Nordic countries (Denmark, Finland, Sweden, and Norway), as shown in figure 4.3. Iceland has traditionally had a trade surplus with Japan (except in 1998 and 1999), the UK, and the United States, but a large deficit against the other Nordic countries.

In figure 4.4 changes in terms of trade over a long period, from 1945, are shown. Terms of trade were highly unstable when mer-

chandise exports were mostly fish products, but in recent years the terms of trade have become more stable. This increased stability reflects increased diversification in the export industries, but stable import prices- especially oil prices (until recently)- have also contributed to this trend.





## 5. Monetary and Exchange Rate Policy

The main monetary policy objective is price stability. A stable exchange rate is the intermediate target of monetary policy. The Central Bank is responsible for implementing monetary policy. The Central Bank mainly pursues its monetary policy by indirect means through market operations, primarily in the money market and the inter-bank market in foreign exchange. The main instrument used by the Central Bank is the repo rate.

### The Functions of the Central Bank

The Central Bank of Iceland (Sedlabanki Islands) was established in 1961. The Board of Directors (consultative) is elected by Parliament for a term of four years. The Prime Minister appoints the Governors of the Bank. The Central Bank of Iceland performs all traditional central banking functions. Through market operations, the Central Bank conducts monetary policy consistent with the goal of maintaining low inflation. The exchange rate policy is formulated jointly by the Central Bank and the Government. The Central Bank holds and manages the nation's foreign exchange reserves. Moreover, the Central Bank acts as the borrowing agent for the Republic of Iceland in international capital markets.

The Treasury and several Government institutions have bank accounts with the Central Bank, which acts as banker, economic

adviser, and fiscal agent for the Government.

The Central Bank sets its own interest rates but the use of some of its instruments is subject to ministerial consent, the most important being the reserve requirement. The Central Bank offers lending facilities to credit institutions and sets reserve requirements. Financial institutions are free to set all their interest rates, with the exception that the Central Bank decides penalty interest rates on overdue payments.

In 1998, the Central Bank of Iceland made significant changes to its monetary policy instruments, modeled on decisions made by the European Central Bank.

Table 5.1 **Money Supply, 1998 - 1999**

<i>Billions of ISK, end of period</i>	<i>1998</i>	<i>1999</i>
Notes and coins	6.3	7.1
Demand deposits	51.9	63.3
Money supply, M1	58.2	70.4
General savings deposits	73.0	66.7
Money supply, M2	131.2	137.2
Time deposits	98.5	132.1
Money supply, M3	229.6	269.2
<i>Percentage increase, 12 months:</i>		
Money supply, M1	20.3	21.1
Money supply, M3	15.2	17.3

*Source:* The Central Bank of Iceland.

Iceland presently has a quota of SDR 117.6 million in the International Monetary Fund. Since 1962, the Central Bank has been a party to an agreement between the Nordic central banks which consists of an exchange of credit lines, allowing each of the banks to draw on the others on a short-term basis in times of temporary foreign reserve shortage. The current agreement is with the central banks of Denmark, Sweden, and Norway. According to the agreement the Central Bank of Iceland can draw up to ECU 200 million. In addition, the Central Bank has access to committed inter-bank lines for a total amount of US\$ 275 million and uncommitted interbank lines with a number of international banks.

### Monetary Policy

A stable exchange rate is the intermediate target of the Central Bank's monetary policy. Market forces have direct influence on the determination of the exchange rate in the inter-bank market for foreign exchange, but the Central Bank is equipped to intervene in that

Table 5.2 **Foreign Exchange Reserves of the Central Bank**

<i>Millions of ISK, end of period</i>	1998	1999
Gross reserves	29,970	35,811
Gold	200	1231
IMF reserve position, SDR	1,042	1,844
Deposits and securities	28,728	34,057
Conversion rate:		
ISK per USD	69.32	72.35

*Source:* The Central Bank of Iceland.

market through market operations to affect the daily exchange rate of the króna.

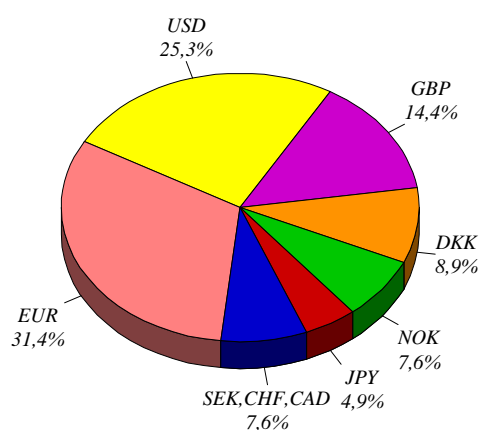
The currency basket, shown in figure 5.1 is composed of 9 currencies, weighted in terms of the respective country's share in trade of goods and services. The basket is revised once a year based on the composition of the previous year's trade in goods and services. The present policy specifies a fluctuation band of  $\pm 9$  percent from a central rate. The Central Bank will use its instruments of monetary policy to keep the exchange rate within this range. In practice, the Central Bank has allowed the exchange rate to move within the band to the extent that it deems such movements consistent with its long-term goal of maintaining low inflation. In mid-2000 the króna was 1.8 percent above the central rate.

The Central Bank imposes a reserve requirement on all credit institutions, at the present in the range of 1.5 to 4.0 percent of total disposable funds, depending on maturity.

In March 1999 the Central Bank set new liquidity requirements for credit institutions. Those rules were primarily prudential in nature aimed firstly to ensure that credit institutions have at all times enough liquidity to be able to meet their obligations and secondly to reduce

Figure 5.1

The Currency Basket Since the Middle of 2000, Based on 1999 Trade Figures



*Source:* Central Bank of Iceland.

the reliance of domestic credit institutions on foreign short term capital to finance their domestic lending activities which had risen sharply in late 1998 and at the beginning of 1999.

In the latter half of the year 1999 the Central Bank and Financial Supervisory Authority in collaboration with credit institution developed new liquidity rules that became effective at the end of the year. These new liquidity rules are based on a completely new approach. Instead of setting a limit on specific liquid assets in relation to disposable funds, the new rules require a maturity analysis of both sides of the balance sheet, including off-balance sheet items, of credit institutions. The new rules demand that liquid claims on the asset side over the coming three months are equal to or exceed liquid claims on the liability side that might arise in the same period.

### **Capital Movements**

Rules and regulations governing inward and outward capital transactions in Iceland have been gradually liberalized. The final step in the liberalization of external capital movements was taken on January 1, 1995, when all restrictions on short-term capital movements were abolished. The regime on external capital movements in Iceland is now in complete accord with the EEA agreement and the regime in the EU countries. Foreign exchange conver-

sions for current payments are unrestricted since a new Act on Foreign Exchange and the Regulation on Foreign Exchange became effective on January 1, 1993. Payments in connection with trade in goods and services are also fully liberalized.

Direct investments and purchases of residential housing abroad by Icelanders are fully liberalized. However, there are still restrictions on direct investments by foreigners in three sectors; fishing and fish processing, the energy sector, and aviation:

- Direct investments by non-residents in fishing and fish processing is prohibited; indirect investment is limited to a maximum of 33 percent.
- Investment in energy production and energy distribution in Iceland is allowed to residents and companies residing inside the EEA. Residents and companies residing outside the EEA can apply for such rights, by having such investment contracts approved by Parliament.
- Investments by residents outside the EEA in aviation companies are restricted to 49 percent.

Foreign borrowing by the Treasury and Government institutions requires authorization by the Parliament. These authorizations are listed in the annual budget approved by the Parliament. In addition, there is a standing authorization to refinance outstanding public debt.

## 6. Financial Markets

Over the last decade the Icelandic financial system has undergone an important transition, generated by liberalization and legislative reforms. The current Central Bank Act was adopted in 1986 and at the same time the final phase in the deregulation of interest rates was completed. In the mid-eighties the Iceland Stock Exchange was established, securities companies emerged, and the first mutual funds were established. Towards the end of the decade a process of rationalization in the banking sector took place through mergers. The BIS standard for rules on capital adequacy of commercial and savings banks became effective in the beginning of 1993. In connection with the Agreement on the European Economic Area (EEA) a new legislation was enacted in 1993 based on EU financial directives. With this legislation, stricter rules were adopted to ensure the economic health of banks and other financial institutions, including rules on a minimum capital ratio and exposure to risk. Bank supervision, now in the hands of the Financial Supervisory Authority, was also strengthened.

### **Credit Institutions**

There are four commercial banks in Iceland, two are majority owned by the Government: Landsbanki Islands Ltd. and Bunadarbanki Islands Ltd. One is a fully private, Islandsbanki - FBA Ltd., and one, Sparisjodabanki Islands

(Icebank Ltd.), is owned by the savings banks. Three of the four commercial banks perform all the traditional banking operations, accept deposits, grant credit, deal in foreign currencies, and maintain accounts with correspondent banks abroad. Landsbanki and Bunadarbanki were converted into limited liability companies as of the beginning of 1998. Initially the State was the sole owner, but there was an authorization to sell new equity up to 35 percent of the current equity. A public offering of 15 percent of new equity in Landsbanki came on the market in September 1998. A similar offering of equity in the Bunadarbanki came on the market in December 1998. A year later the Government sold an additional 15 percent of its shares in these banks to the public.

Icebank functions as the banking institution for the 29 savings banks. The savings banks are generally private institutions with local operations, and they perform most traditional banking operations. In addition to commercial and savings banks, there are two other types of deposit receiving institutions, namely the savings departments of the cooperatives and the Post Giro.

The FBA - The Icelandic Investment Bank, was created by a merger of four investment credit funds and initially fully owned by the Government. It has operated since the

beginning of 1998. The bank was fully privatized in 1999.

In April 2000, Islandsbanki and FBA signed a memorandum of intent on a merger, which led to the establishment of a new company under the name Islandsbanki-FBA. The new bank formally commenced operations in June.

A new State Housing Fund began operations in the beginning of 1999, replacing the previous housing institution. The new fund is based on legislation, approved by the Parliament in June 1998, aimed at rationalizing the existing state housing fund system.

The three existing leasing companies have recently diversified their activities by granting loans in addition to concluding conventional leasing contracts.

### **The Securities Market**

The securities market has expanded rapidly in recent years. Since 1964, the Government has issued indexed Government bonds, and in the 1980s, a secondary market for these bonds began to develop. In recent years, there has been an increase in the variety and volume of

financial instruments that the Government, municipalities, and financial institutions have offered on the market.

The bond market, along with the money and equity markets, has continued to develop. Two milestones in the development of the bond market were the introduction of the Housing Bond system in 1989, with tradable securities, and Government securities auctions where Treasury bills, Treasury notes, and Government savings bonds have been offered in regular auctions since 1992. At that time marketable bonds and money market instruments equaled 6 percent of GDP, but at the end of 1999, they amounted to about 66 percent of GDP.

The extensive practice of indexation of financial obligations in Iceland has been one of the main characteristics of the domestic financial market. Indexation was brought into the financial market during a period when Iceland suffered a high rate of inflation and a rapid decline in monetary savings. The two-tier system of indexed and non-indexed obligations has tended to cause nominal interest rates to change in accordance with inflationary trends

Table 6.1 **Selected Market Securities**

<i>Millions of krónur, end of year</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
Treasury bills	15,459	16,803	12,296	15,207	9,899
Bank bills	4,028	8,106	13,427	8,014	11,860
Treasury bonds	77,959	77,360	86,925	84,960	84,286
Treasury notes	6,577	10,349	13,280	19,602	13,369
Bank bonds	20,067	24,062	27,307	45,421	51,077
Housing bonds	77,637	92,052	107,852	127,238	146,732
State housing fund bonds	7,603	13,013	17,716	23,837	33,950
Bonds issued by other inv. credit funds	17,497	17,235	17,169	19,893	24,800
Bonds issued by leasing companies	4,866	6,903	8,533	7,671	9,237
Mutual funds units (open-end)	14,517	20,533	33,397	72,644	89,052
Shares (market capitalisation)	65,327	94,802	151,009	233,200	369,835

Source: The Central Bank of Iceland.

rather than as a reflection of changes in credit supply and demand. As price stability has taken hold, indexation is receding from the short-term financial market.

The Iceland Stock Exchange (ISE) was established in 1985 and now operates under new legislation adopted in 1998. The new act required the Icelandic Stock Exchange to be converted into a limited liability company (implemented in 1999), abolished its monopoly on exchange activities, but at the same time gave it increased room to grow and offer new services. Currently, there are twenty members of the Exchange, including the Central Bank, all the commercial banks and securities companies and some savings banks. Among securities listed on the exchange are the stocks of between 70 and 80 companies, Government bonds, notes and bills, and various private bond issues, primarily by credit institutions. Listing on the Exchange is subject to listing requirements set by the Exchange, including disclosure requirements. Electronic securities registration began in 2000. In addition, ISE became a member of the Nordic Stock Exchange Market, NOREX, in the year 2000.

Turnover on the exchange has risen rapidly in recent years. At the end of 1999, the market capitalization of listed securities was ISK 850 billion or 33 percent of GDP. Of this sum ISK 445 billion were bonds, ISK 370 billion equities, and ISK 35 billion money market instruments.

The largest brokers have operated a non-regulated over-the-counter (OTC) market for non-listed shares since 1992.

### **Institutional investors**

At the end of 1999, there were 62 pension funds in Iceland. Their number has decreased in recent years due to mergers. More mergers are on the horizon. The pension funds receive payments from employers and employees and are the most important source of long-term

finance in the country. The pension funds have traditionally invested in bonds issued by the Treasury, other financial institutions, municipalities, and companies. They also extend credit to members. About 25 percent of their assets are in Icelandic and foreign equity and in mutual funds. In recent years the pension funds have started to invest in foreign securities.

In 1985, mutual funds were first established in Iceland. Ten closed-end mutual funds are now in operation. They are limited liability companies, and are quoted on the Iceland Stock Exchange. There are five open-end mutual funds that are operated in 31 divisions. Credit institutions also operate mutual funds quoted on the Luxembourg Stock Exchange and on the Channel Islands.

There are now 14 insurance companies licensed to operate in Iceland. Three of them are life-insurance companies, representing only 4.8 percent of total assets of the companies. One reason for the relatively small share of life insurance can probably be traced to the employees' compulsory membership in pension funds. Almost 60 percent of the insurance companies' portfolio consists of marketable securities, which make them fairly sizeable investors in the Icelandic securities market. In addition, 156 foreign insurance companies have licenses to provide services in Iceland, two of which have established branches.

### **Supervision and regulations**

The Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority were merged into a separate entity, Fjarmalaeftirlitid, the Financial Supervisory Authority (FSA), on January 1, 1999. The FSA has a Board of Directors appointed by the Minister of Commerce. The institution supervises commercial banks, savings banks, and other credit institutions, insurance companies, companies and individuals acting as insurance brokers,

undertakings engaged in securities services, mutual funds, management companies, stock exchanges and other regulated markets, central securities depositories (CSD), and pension funds. The Financial Supervisory Authority also supervises other activities, which the institution has been authorized to supervise in accordance with special laws.

The main task of the Financial Supervisory Authority is to ensure that the activities of the above institutions and firms are conducted in accordance with the relevant laws and regulations and that they remain sound in other respects. These institutions and firms are obligated to provide all the information considered necessary by the Financial Supervisory Authority to facilitate statutory supervision of their activities.

The Icelandic legislation and regulations regarding credit institutions and other financial institutions have been adapted to the various regulations and directives of the European Union as a consequence of Iceland's participation in the European Economic Area.

The current rules on capital adequacy for credit institutions and securities firms are based on the Basel Guidelines and the EU Capital Adequacy Directive, with a minimum capital ratio of 8 percent. According to rules imposed by the Central Bank, commercial and savings banks are limited in their foreign exchange exposure to 30 percent of equity as defined by the Capital Adequacy Rules (CAD) rules. The same applies to indexed assets and liabilities.

A deposit insurance scheme is in force. The commercial and savings banks have annually contributed 0.15 percent of their deposits to this scheme (until the limit of 1 percent of total insured deposits is reached). Since the beginning of the year 2000, the insurance fund of the commercial banks and the savings banks is a private institution. An insurance scheme also comprises equity investors that are covered in a special department in this institution.

## 7. Public Finance and Foreign Debt

After heavy deficit spending in the eighties, Treasury finances were stabilized by the end of the nineties. In the late nineties, fiscal deficits have been well below the OECD average, and Iceland has fully met the Maastricht criteria for general Government finances since 1999. By preliminary estimates, the fiscal balance of general Government was in surplus by 0.5 to 1 percent of GDP in 1999. The surplus is expected to be 2.5-3 percent of GDP in the year 2000. Total Treasury debt amounted to ISK 237 billion at the end of 1998 and preliminary estimates put it at ISK 217 billion at the end of 1999. According to debt repayment plans, it should decline to nearly ISK 200 billion by the end of this year.

### The Size and Nature of the Icelandic Government Sector

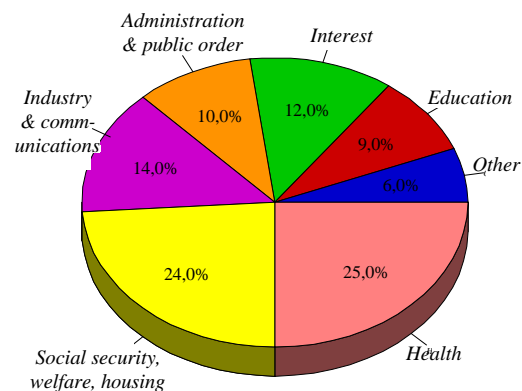
Compared to European countries, Iceland has a relatively small public sector, which has shrunk in recent years relative to GDP. General government expenditures have fallen from a relatively steady 40 percent of GDP in the period 1988-1994 to an estimated 37.5 percent in 1999 while revenues have held steady between 36 and 37 percent of GDP and even climbed to an estimated 38 percent of GDP in 1999. Through this process, serious fiscal deficit has been corrected. During this period of declining expenditures, Government consumption has actually increased while current transfers have

hardly budged. Subsidies and capital transfers have borne most of the decrease. The reduction in subsidies ties in with changes in agricultural support in the early 1990s, while the reduction in capital transfers is concentrated in agriculture and housing. On the revenue side, there is a clear switch from indirect taxes on goods and services to direct taxes on income and wealth, the increase occurring mostly through broadening of the tax base rather than rate hikes.

The most obvious reasons for the Icelandic Government sector being smaller

Figure 7.1

Expenditure Structure of Central Government 1998



Source: National Economic Institute.



than those of its European neighbors is a much smaller welfare sector than, for example, in the other Nordic countries. More precisely, expenditure on unemployment benefits is a significantly smaller percentage of GDP in Iceland than in the Nordic countries (0.7 percent of GDP versus 3.4 percent unweighed average for other Nordic countries in 1996). The same goes for total pension payments, even if private sector pension funds are included (7.7 percent of GDP in Iceland versus 15.3 percent for other Nordic countries in 1996). Lower expenditure on unemployment is easily understood given the low unemployment rate and relatively low payments to each unemployed person. A younger population and a higher retirement age partially explain lower pension expenditures, while the rest is due to lower payments per recipient.

### The division of responsibility

The local authorities are responsible for road construction and planning, for education from pre-school through the 10th grade, for welfare

services of all kinds, in particular for the care of the disabled and elderly outside institutions, and for solving housing problems of those who cannot find housing on their own. In the area of welfare, local governments provide supplementary assistance to general programs of pensions otherwise run by central Government. The central Government center is responsible for the police, courts and foreign service, higher education, health service, institutional care for the disabled and elderly, and general support and services for industry. It administers basic old-age and disability pensions, means-tested rebates on housing-related interest payments and means-tested benefits to families with children. In the last few years, local government expenditures have run around 10 percent of GDP as against a central Government budget of around 28 percent of GDP.

### The Budget Process of the Central Government

The Icelandic Constitution requires the authorization of Parliament (Althingi) for all central

Figure 7.2

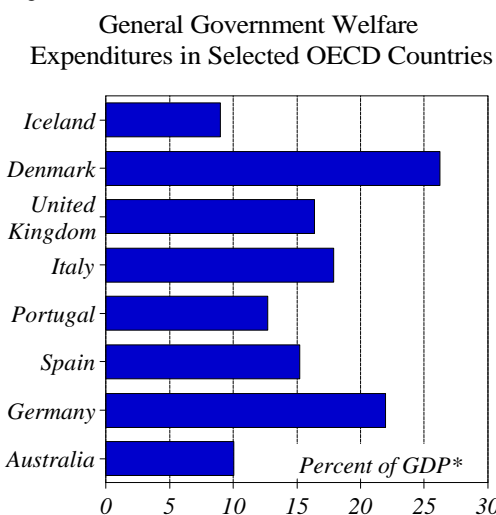
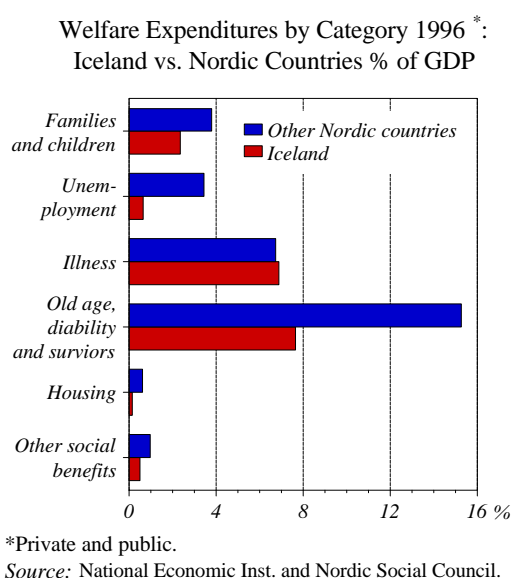


Figure 7.3



Government expenditures, taxation, and borrowing. The fiscal year coincides with the calendar year. The budget proposal for the coming year is presented to the Parliament at the beginning of each regular session in early October and usually passed by the third week of December. A supplementary budget bill is almost invariably introduced in the next fall session and a third bill accompanies the accounts of each year to the Parliament. The use of supplementary appropriations has become more measured with the slowing of inflation in this decade. The central Government's accounts are subject to audits and control by the General Auditor's Office (Rikisendurskodun), an independent entity under the Parliament.

### **Accounting Standards**

Three fundamental changes were made to the presentation of the budget and the central Government's accounts in the beginning of 1998: First, the budget is now presented on accruals basis, containing authorizations to commit to expenditures. The Government accounts have been based on accruals since 1965, but until 1998, the budget consisted of authorizations for payments. The difference between payments and accruals is quite significant at times for items such as interest on bullet bonds, increases in pension liabilities, and write-offs of tax claims. Second, the budget now itemizes grants for numerous activities, which were previously off-budget but financed by levies set by law. Third, significant expenditures, which were previously shown as subtracted from revenues, are now shown explicitly as expenditures. These expenditure items include child and housing benefits as well as payments to the State Church and other established religious groups. These changes, put into effect with the 1998 budget, boosted the total budget numbers by 20 percent and Treasury account totals by somewhat less.

### **The Tax System**

The Central government, as represented by the Treasury, derived (in 1998) close to 90 percent of its revenue from taxes, of which roughly 27 percent comes from direct taxes on income and wealth and 63 percent comes from indirect taxes.

A 26.4 percent tax is levied on personal income up to ISK 3.3 million, while higher income is charged an additional 7 percent. A tax credit of approximately ISK 280,000 per year implies that an individual's annual income of up to around ISK 1 million or US\$ 15,000 is tax-free. For individuals with lower income, the tax credit applies towards a local Government income tax, which ranges from 11.24 to 12.04 percent, depending on municipality. Accordingly, individuals with an annual income of up to around US\$ 10,000 dollars are exempt from general income taxes. The combined average rate of general and municipal income taxes has been reduced in steps from 42 percent in 1996 to 38.4 percent at the beginning of 1999.

Since 1990, the municipal income tax has risen from an average 7 percent to 11.96 percent in response to the abolition of a turnover-tax on businesses in 1993 and again to compensate for increasing responsibilities of local governments in the area of primary education.

Interest, dividend, and rental income of individuals, as well as capital gains up to approximately ISK 3 million are taxed at a lower rate of 10 percent. This percentage represents final taxation on this income. A net wealth tax of 1.2 percent is assessed to net assets exceeding ISK 3.8 million for individuals.

Corporations pay a 30 percent tax on profits. This rate has come down from 50 percent in 1991. Capital income of corporations is treated like other revenue for tax purposes.

Corporations pay 1.2 percent tax on net wealth.

A payroll tax of 5.14 percent is charged on wages, in addition to which employers must contribute at least 6 percent to a pension fund to match an employee contribution of at least 4 percent. Although membership is mandatory and the operations of pension funds are regulated and their charters must be approved by the Treasury, the funds are independently managed and considered independent of Government.

The largest single source of Treasury revenue is a value added tax, which is levied at 24.5 percent on most goods and services. Services of hotels and guesthouses, broadcasting services, newspapers, heating fuel, and foodstuffs are taxed at 14 percent, while certain services, including health services and passenger transportation, are exempt.

Excise taxes are levied on a range of

goods at three rates, while some goods are charged unit fees. The custom duty is in the range of 0-30 percent, but most imports from EFTA and EU countries are exempt from the duty. With the implementation of the EEA agreement as of January 1, 1994, all customs duties on manufactured goods, imported from countries that have implemented the EEA agreement, have been abolished. The revenue from excise taxes and import duties has fallen from around 1.5 percent and 3 percent of GDP in the early 1980s to around 0.5 and 0.4 percent in 1998.

There is a stamp duty on larger financial transactions as well as on most bank transactions. Taxes on the ownership of motor vehicles and excise taxes on gasoline make up between 7 and 8 percent of Treasury revenue, while between 4 and 5 percent is derived from charges on the sale of alcohol and tobacco.

The taxes described above accounted for close to 95 percent of Treasury tax revenue. Non-tax income accounts for just over 10 percent of Treasury revenue and consists mostly of interest income, dividends, profits from sale of government assets, and charges for services.

Table 7.1 **Composition of General Government Revenues and Expenditures as % of GDP**

	90-92	96-98	Change
Property income	2.6	2.3	-0.3
Direct taxes	12.2	14.5	2.3
Indirect taxes	22.0	19.9	-2.1
Other non-tax	0.1	0.1	0.0
Total revenues	37.0	36.8	-0.2
Government			
final consumption	19.7	20.2	0.5
Interest payments	4.0	3.8	-0.2
Subsidies	7.3	5.0	-2.3
Current transfers	11.7	11.0	-0.6
Fixed investment	10.7	9.1	-1.6
Capital transfers	5.8	3.9	-2.0
Total expenditures	40.3	37.2	-3.2

Source: National Economic Institute, Central Bank of Iceland

### Local government finances.

At the beginning of 2000, Iceland was divided into 124 municipalities, of which nine have a population exceeding 5,000. The number of municipalities has decreased from 224 in 1980 due to mergers. In the same period, the municipalities have taken on increasing responsibilities, especially in the area of compulsory education, while in area of healthcare, some tasks have been handed over to central Government. The expenditures of local governments have expanded from around 6.5 percent of GDP in the early 1980s to 9.5 percent of GDP in the late 1990s, with increased education responsibilities accounting for more than 1 percent of GDP. The composition of local government expenditure is shown in figure 7.4.

The municipal income tax is the major source of local government revenue, accounting in 1997 for 54 percent of total revenue with another 10 percent coming from real estate taxes, an additional 22 percent from service charges, and 5 percent coming from the Municipal Equalization Fund.

The finances of central and local Government are interrelated in many ways. Many public services and investment projects are jointly financed. The intertwining of state and local income taxes was described in the section on the tax system. The Municipal Equalization Fund, which is jointly financed by central and local Government tax revenue, has the obvious role of enhancing the revenues of weak municipalities, with emphasis on education expenses and infrastructure investment.

In many instances, local government owns and operates major utilities. Waterworks and harbor facilities are almost invariably owned by the community, as are geothermal heating systems, where they exist. A few communities own their electrical distribution system, the rest being served by a state-owned

company. In the capital region, several communities are served by the heating and electricity distributor in Reykjavik, which thus serves almost 60 percent of the Icelandic population. Finally, the National Power Company, which produces 95 percent of total electricity in the country, and Iceland State Electricity, the main rural distributor of electricity, are Government controlled.

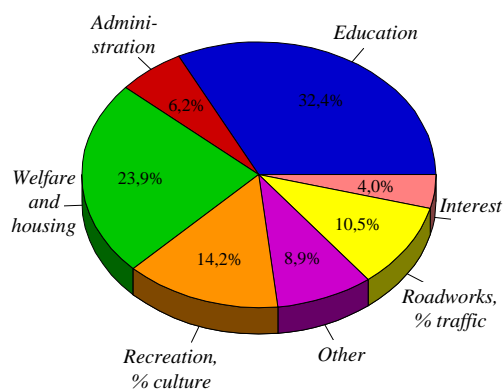
### Treasury Foreign Debt

The Republic of Iceland has been the largest and most active Icelandic borrower in international markets. In recent years, the surplus on government finances has led to a reduction in the total outstanding foreign debt. The Treasury foreign debt to GDP ratio has fallen from 28 percent in 1995 to 18 percent in 1999.

A primary aim in debt management is to spread the amortization of foreign loans evenly over coming years as well as to achieve a favorable composition of the debt in regard to interest rates, maturity, and currency denomination. In recent years prepayment options have been exercised in order to refinance debt

Figure 7.4

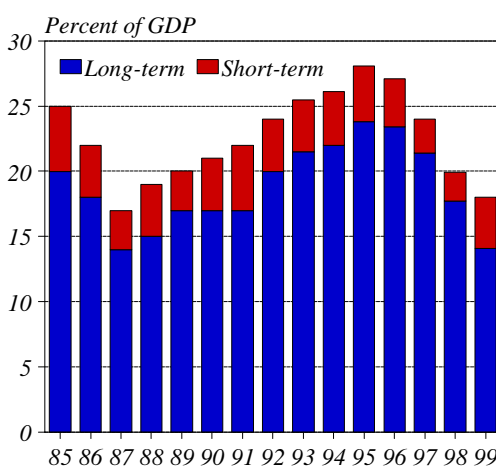
Expenditure Structure of Local Government 1998



Source: National Economic Institute.

Figure 7.5

Treasury Foreign Debt 1985-1999, End of Year



Source: Central Bank of Iceland.

on more favorable terms. Interest rate and currency swaps have also been used to achieve debt management objectives.

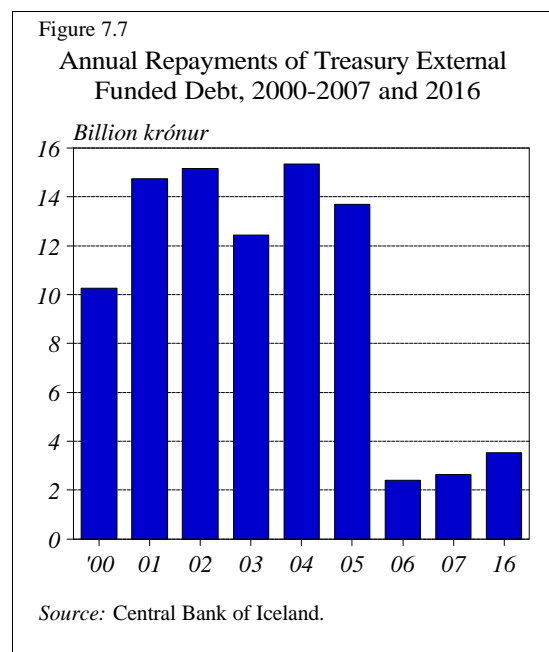
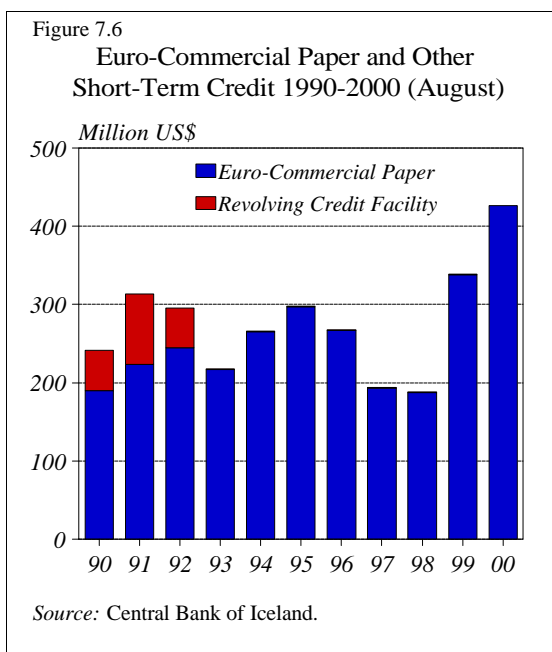
At year-end 1999, the Treasury's long-term foreign debt amounted to ISK 114.8 billion and the outstanding stock of Euro-commercial papers stood at ISK 28 billion. Around 27.6 percent of the Treasury's foreign obligations were denominated in US dollars, 14.3 percent in Japanese yen, and around 58.2 percent were denominated in various European currencies.

At year-end 1999, 62 percent of the Treasury's total foreign debt carried fixed interest rates. Of the long-term debt, 68 percent of loans carried fixed rates of interest. The average maturity of the foreign long-term debt was 3.6 years and the average duration 2.2 years. Including the short-term debt, these numbers are 2.9 years and 1.8 years, respectively.

The Republic of Iceland Euro-Commercial Program plays an important role in the foreign financing of the Republic. The size of the program has been increased gradually from

US\$ 50 million in 1985 to US\$ 500 million in 1995. The program has been assigned the highest possible short-term ratings of A-1+ by Standard & Poor's and P-1 by Moody's. A multi-currency option allows for issuance in alternate currencies. The paper is issued at a spread of approximately ten basis points below LIBOR. Currently there are four dealers on the program: Citibank International, SEB in London, JP Morgan, and Deutsche Bank. Amount, maturity, and yield are negotiated at the time of issuance in view of market conditions.

In 1990, the Parliament enacted legislation to provide for the establishment of the National Debt Management Agency (Lanasysla Rikisins) or (NDMA). The NDMA commenced operations in June 1990. Under this legislation, borrowing and debt management functions of the Treasury, both domestic and foreign, and government guarantees have been assigned to the NDMA. Under a special agreement with the Minister of Finance, the Central Bank is responsible for the execution of foreign borrowings for the Treasury.



The Republic of Iceland has always paid when due the full amount required in respect to principal, interest and sinking fund installments for all internal and external obligations.

### National Debt

Reported figures in the coverage of Icelandic foreign debt statistics include private as well as public debt: Total external debt of the economy amounted to ISK 548 billion at the end of 1999. The net external debt of the Icelandic Government, financial institutions, and the private sector (international investment position) amounted to ISK 306 billion (around US\$ 4.2 billion), or 48 percent of GDP. This ratio peaked at 56 percent at year-end 1993. The fluctuations in the debt ratio do not only reflect changes in the volume of debt but also the volatility of exchange rates. The debt service ratio peaked at 34 percent in 1996 but declined to about 25 percent in 1999.

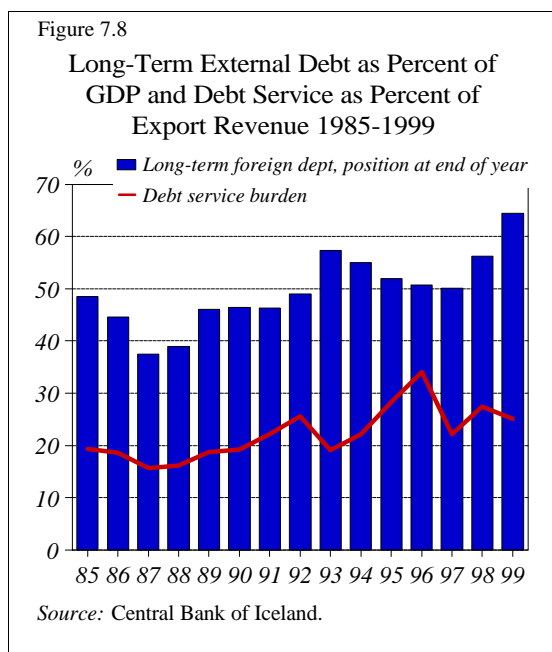
### Credit Ratings

In 1996 and 1997 Moody's and Standard &

Poor's upgraded Iceland's credit rating to reflect the country's increased creditworthiness. Standard & Poor's announced in 1996 that it had upgraded the credit rating for the Republic of Iceland's long-term foreign currency denominated debt from A to A+, and short-term debt from A-1 to A-1+. Furthermore, Standard & Poor's assigned a first time rating of AA+ to Iceland's long-term local currency debt. In July 1997, Moody's upgraded the Republic's foreign currency rating to Aa3 and assigned Aaa rating to the Republic's long-term krónur bonds. In its press release announcing the rating upgrade Moody's made a reference to increased diversification in the Icelandic economy as a consequence of an influx of new foreign investment projects that take account of the country's clear comparative advantages such as abundant renewable geothermal and hydro energy and environmentally friendly tourism. Further, the improved ratings reflect the wide-spread restructuring and stabilization of the Icelandic economy in the past years -coupled with strong economic growth, low inflation, declining debt service and falling debt ratios.

In December 1999, Moody's and Standard & Poor's confirmed their previous ratings. Standard & Poor's also announced a positive outlook on Iceland's long-term foreign currency debt rating.

In February 2000 the international rating agency Fitch IBCA assigned a AA- long-term foreign currency rating for Iceland. A short-term rating of F1+ and a AAA for long-term local currency rating was also assigned. In its report, Fitch IBCA said that long-term prospects for the Icelandic economy have improved in recent years, supported by progress with structural reform. A major fiscal consolidation program in conjunction with funds raised from the accelerated privatization program have generated growing budget surpluses and enabled the authorities to start



amortizing the general Government's debt. The booming economy has, however, clearly overheated, and Iceland's already high external debt ratios have worsened. As liquid liabilities are well in excess of liquid assets, Iceland will remain vulnerable to changes in sentiment until tightened fiscal policy and interest rate hikes by the Central Bank bear fruit.

## 8. Appendix

Table A1. **Iceland's Membership in International Organisations**

	<u>Year of Association</u>
International Monetary Fund (IMF)	1945
International Bank for Reconstruction and Development (World Bank)	1945
United Nations (UN)	1946
North Atlantic Treaty Organization (NATO)	1949
Organization for Economic Cooperation and Development (OECD)	1949
Council of Europe	1950
Nordic Council	1952
International Finance Corporation (IFC)	1956
International Development Association (IDA)	1961
General Agreement on Tariffs and Trade (GATT)	1964
European Free Trade Association (EFTA)	1970
Conference on Security and Cooperation in Europe (CSCE)	1975
Western European Union (WEU)	1992
European Economic Area (EEA)	1994
World Trade Organization (WTO)	1995



Table A2. **Output and Expenditure 1999-2000, Volume Changes 1997-2000**

	<i>Billions of krónur</i>		<i>Percent change from previous year</i>			
	<i>1999P</i>	<i>2000F</i>	<i>1997</i>	<i>1998P</i>	<i>1999P</i>	<i>2000F</i>
Private consumption	400.2	438.2	6.0	11.0	7.2	4.0
Public consumption	138.0	151.2	3.1	3.6	4.7	3.5
Gross fixed investment	127.0	140.4	10.5	25.9	-2.0	8.4
Stock changes	0.139	0	0.0	0.1	-0.1	0.0
Total national expenditure	665.3	729.9	6.2	12.5	4.7	4.7
Exports of goods and services	215.0	219.1	5.7	2.2	5.8	1.8
Imports of goods and services	242.9	251.7	8.5	23.3	6.3	4.1
Gross domestic product	637.6	697.3	5.3	4.7	4.4	3.9
Net factor income from abroad	-14.2	-17.0	-	-	-	-
Current transfers, net	-0.7	-0.9	-	-	-	-
Current account balance	-42.7	-50.4	-	-	-	-
Gross national product	623.4	680.3	4.9	4.6	3.9	3.6
Effects of changes in terms of trade	-	-	1.0	1.9	0.3	0.4
Gross national income	-	-	6.0	6.5	4.1	4.0
Current balance, percent of GDP	-	-	-1.7	-6.8	-6.7	-7.2

P = provisional figures, E= Estimation, F = forecast, volume changes in 1990 prices.

Source: National Economic Institute, December 1999.

Table A3. **Balance of Payments 1997-1999**

<i>Millions of krónur</i>	1997	1998	1999	
<i>A Current Account</i> .....	-8,899	-40,054	--43.200	
1 Balance on Goods .....	254	-25,019	-22,374	
11 Merchandise exports fob .....	131,213	136,592	144,957	
111 Marine products .....	93,648	99,233	97,711	
112 Miscellaneous .....	37,565	37,359	47,246	
12 Merchandise imports fob.....	-130,959	-161,611	-167,331	
121 Investment goods.....	-50,719	-68,168	-70,645	
122 Other goods .....	-80,240	-93,443	-96,686	
2 Balance on Services .....	2,977	-1,310	-5,695	
21 Exports of services, total .....	59,735	67,134	69,406	
211 Transportation .....	25,735	31,109	29,849	
212 Travel.....	12,316	14,633	16,424	
213 Other receipts .....	21,684	21,392	23,133	
22 Imports of services, total .....	-56,758	-68,444	-75,101	
221 Transportation .....	-17,916	-22,766	-25,546	
222 Travel.....	-22,893	-28,049	-31,101	
223 Other expenditures .....	-15,949	-17,629	-18,454	
3 Balance on Income .....	-11,892	-12,722	-14,406	
31 Receipts .....	7,327	8,480	7,609	
311 Compensation of employees .....	4,128	4,742	4,901	
312 Investment income .....	3,199	3,742	2,708	
32 Expenditures .....	-19,219	-21,203	-22,015	
321 Compensation of employees .....	-391	-293	-341	
322 Investment income .....	-18,828	-20,909	-21,982	
4 Current transfer, net .....	-238	-1,003	-725	
<i>B Capital and Financial Account</i> .....	14,878	43,769	58,126	
5 Capital transfer, net .....	14	-324	-57	
6 Financial Account .....	16,887	45,824	63,373	
61 Financial Account excl, Reserves .....	13,703	48,085	68,719	
611 Direct investment, net .....	6,628	5,374	692	
6111 Abroad .....	-3,637	-5,021	-5,089	
6112 In Iceland .....	10,265	10,395	5,781	
612 Portfolio investment, net .....	-17,246	-16,828	43,293	
6121 Assets.....	-14,435	-21,534	-27,740	
6122 Liabilities .....	-2,811	4,706	71,033	
613 Other capital, net * .....	24,321	59,539	24,734	
6131 Assets.....	-11,575	270	-12,662	
6132...Liabilities .....	35,896	59,269	37,396	
62 Reserve assets .....	3,184	-2,261	-5,346	
A+B Net errors and omissions .....	-8,002	-5,449	-20,116	
	<i>*Memorandum items:</i>			
	Long-term borrowing, net	20,543	62,783	37,182
	Foreign borrowing	39,256	84,619	48,047
	Amortisation1	-18,713	-21,836	-10,865
	Short-term borrowing, net	3,788	-3,224	-12,448
Exchange rate: ISK per USD	70.76	70.95	72.22	

Table A4. **Imports by Economic Category, 1996-1999**<sup>1</sup>

<i>Millions of krónur, cif</i>	1996	1997	1998	1999
Food and beverages	12,692	12,849	16,037	17,505
Primary, mainly for industry	2,67	2,478	4,585	5,478
Primary, mainly for household consumption	1,805	1,925	1,988	2,042
Processed, mainly for industry	1,212	1,051	1,128	1,088
Processed, mainly for household consumption	7,007	7,395	8,337	8,897
Industrial supplies not elsewhere specified	36,593	37,593	46,078	43,849
Primary	1,973	2,079	3,193	1,954
Processed	34,975	35,514	42,885	41,895
Fuels and lubricants	10,454	10,712	8,898	9,752
Primary	392	353	428	330
Petrol, including aircraft fuel	2,085	2,035	1,748	1,922
Other	7,978	8,324	6,721	7,501
Capital goods, parts and accessories	29,906	34,778	44,739	43,817
Capital goods (except transport equipment)	20,183	22,317	29,166	28,373
Parts and accessories	9,723	12,461	15,573	15,444
Transport equipment	19,38	19,435	27,624	31,306
Passenger motor cars	7,095	9,06	11,792	14,250
Industrial	2,105	2,733	3,428	3,780
Non-industrial	323	309	365	547
Parts and accessories	3,4	4,072	4,12	4,482
Ships	6,35	3,102	4,409	4,842
Aircraft	107	160	3,511	3,405
Consumer goods not elsewhere specified	26,227	27,623	32,406	35,877
Durable	5,917	6,3	7,894	9,017
Semi-durable	10,234	10,745	12,429	13,404
Non-durable	10,077	10,578	12,083	13,456
Goods not elsewhere specified	386	237	332	237
Total imports of goods cif	135,994	143,227	176,114	182,344

1. Current exchange rates.

Source: Statistics Iceland.

Table A5. Exports by Commodity Groups, 1996-1999<sup>1</sup>

<i>Millions of krónur, fob</i>	1996	1997	1998	1999
Marine products	92,582	93,648	99,28	97,711
White fish	54,505	55,522	63,936	69,350
Frozen	30,944	31,055	36,84	38,46
On ice	6,851	7,46	8,072	10,187
Salted	14,914	14,85	17,272	19,349
Stockfish	694	1,003	1,023	1,024
Meal	785	840	422	-
Oil	318	314	306	330
Herring and capelin	18,228	17,751	17,409	10,939
Frozen	5,586	4,123	2,833	776
Salted	1,054	760	800	724
Meal	8,034	8,578	9,472	7,415
Oil	3,553	4,29	4,304	2,024
Lobster, shrimp, scallop	17,258	16,899	14,598	12,920
Other	2,591	3,475	3,337	4,502
Agricultural products	2,55	2,105	1,967	2,141
Meat	469	229	193	214
Dairy products	12	0	0	0
Salmon & trout (fish-farming)	712	661	666	582
Other	1,356	1,216	1,107	1344
Manufacturing products	25,039	28,757	31,455	37,099
Aluminium	12,104	15,197	18,417	22,540
Ferro-silicon	3,813	3,709	3,212	3,129
Diatomite	596	572	548	627
Tanned skins and hides	1,193	1,2	624	385
Woollen products	357	382	378	266,2
Canned products	1,567	1,919	1,751	1,483
Other	5,408	5,778	6,526	6,273
Miscellaneous	5,52	6,704	3,897	8,007
Total merchandise exports	125,69	131,213	136,598	144,957

1. Based on current exchange rates.

Source: Statistics Iceland.

Table A6. **Geographic Distribution of Foreign Trade, 1997-1999**

<i>Percentages of total values</i>	<i>Imports</i>			<i>Exports</i>		
	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
EFTA	13.8	10.7	11.5	8.6	9.4	8.5
Norway	11.5	9.2	10.4	5.6	4.8	4.8
Switzerland	2.2	1.5	1.1	3.0	4.6	3.7
EU	58.1	56.2	56.1	60.6	65.0	64.2
Austria	0.6	0.6	0.7	0.1	0.1	0.1
Belgium	2	1.9	1.7	1.1	1.3	1.4
United Kingdom	10.1	9.7	9.2	18.9	19.0	19.7
Denmark	8.6	7.7	8.1	5.7	5.5	4.6
Finland	1.6	1.6	1.6	1.1	0.7	0.5
France	3.3	3.6	3.8	6.3	6.8	5.2
Greece	0.1	0.1	0.1	0.6	0.5	0.6
Netherlands	6.5	5.9	5.2	3.3	4.1	6.0
Ireland	1.2	1.5	1.5	0.2	0.4	0.3
Italy	3.2	3.2	3.4	1.8	1.7	1.7
Luxembourg	0.1	0.1	0.0	0.2	0.3	0.1
Portugal	0.7	0.7	0.7	2.6	3.8	4.8
Spain	1.6	2.0	2.0	4.4	5.0	5.2
Sweden	6.7	6.3	6.3	1.1	0.9	0.9
Germany	11.8	11.5	11.8	13.1	15.0	13.1
EEA <sup>1</sup>	69.6	65.4	66.5	66.1	69.8	69.0
Other Europe	4.8	6.3	5.4	4.3	2.8	3.1
Russia	2.5	2.2	1.9	1.8	1.1	0.3
Other	2.3	4.1	3.5	2.5	1.7	2.8
North-America	10.5	12.8	11.7	15.2	15.4	16.2
United States	9.4	11.1	10.9	13.9	13.2	14.7
Canada	1	0.8	0.8	1.2	1.5	1.5
Asia	10.2	10.7	9.9	9.1	6.3	6.2
Japan	4.9	5.1	5.5	6.6	4.8	5.0
Oceania	1.8	3.2	2.7	0.1	0.1	0.2
Other countries	7.9	5.6	2.7	4.7	1.5	1.6
Total	100	100	100	100	100	100

1. The EU and the EFTA countries except Switzerland.

Source: Statistics Iceland.

Table A7. **Projected External Debt Service**<sup>1</sup>Table A7. Projected external debt service<sup>1</sup>

Billions of krónur <sup>2</sup>	2000	2001	2002	2003	2004	2005	Principal thereafter	Principal Total
<b>General governments</b>								
Principal	11,1	16,4	17,2	13,9	16,9	3,9	30,6	110,1
Interest <sup>3</sup>	6,2	5,4	5,1	4,1	2,5	1,9		
Total	17,3	21,8	22,3	17,9	19,4	5,8		
<b>Financial institutions</b>								
Principal	31,4	14,1	37,6	68,1	36,5	7,6	5,6	200,8
Interest <sup>3</sup>	8,7	7,5	6,5	5,0	1,7	0,5		
Total	40,1	21,6	44,1	73,1	38,3	8,1		
<b>Other sector</b>								
Principal	9,0	16,8	7,4	29,9	25,6	8,9	10,9	108,4
Interest <sup>3</sup>	5,8	4,9	4,0	3,3	2,3	1,1		
Total	14,8	21,7	11,3	33,2	27,9	10,1		
<b>Total payments</b>								
Principal	51,4	47,3	62,1	111,9	79,0	20,4	47,0	419,2
Interest <sup>3</sup>	20,7	17,8	15,6	12,4	6,5	3,6		
Total	72,2	65,1	77,7	124,3	85,5	24,0		

1. Based on debt outstanding at the end of year 1999.

2. Exchange rates at the end of 1999.

3. US dollar Libor is assumed at 6 % per year.

Source: The Central Bank of Iceland.